THE THEORY AND PRACTICE OF FINANCE

THE THEORY AND PRACTICE OF FINANCE

BY

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SECOND EDITION

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AUTHOR'S NOTE

DEDICATIONS to works of this kind are not usual, but I take leave to dedicate this book to the memory of W. E. Brooks—1864–1914—a man born without fear and without guile, whose greatness of heart caused him to waste on unworthy objects the manifold resources of a remarkable personality; to whose influence in formative years I owe whatever grasp of finance and commerce I possess; and to whom I am indebted for much more than the transmitted teachings of Lord Goschen, which are all that can fittingly be acknowledged here.

PREFACE
TO THE SECOND EDITION

Of the many manifestations of kindness called forth by the publication of this book two have been particularly gratifying: the very generous commendations of the professional critics and the demand of the public for a second edition in so short a time. I wrote the book because, in my experience, there was not otherwise available between two covers a survey of the whole field of finance, and because I felt that the majority of textbooks on isolated phases of the subject are either too technical or too "dry" for the average reader, fascinating as they may be to the specialist. The welcome given to this volume would seem to indicate that my feeling was well founded.

If the public and critics welcomed the first edition, I welcome the opportunity of preparing a second. The work from many quarters has been hailed and reported as authoritative, comprehensive, witty, amusing, instructive, able, and helpful, and of "inestimable value." In the words of the happily dead Press Bureau, "while not guaranteeing the accuracy of this report, I have no objections to its publication." But I have been made aware of one or two ways in which the book could be improved.

The Companies (Consolidation) Act of 1929 had not received the Royal Assent when the book was written, and did not become operative until six weeks after its publication. I was able when the work was actually going through the Press to amend such chapters as were affected by the Royal Assent and to anticipate the effect of the operation of the Act from November 1st. In

this edition I have dealt with the Act as a statute in being.

The new Bank for International Settlements also now receives attention, its statutes being published too late for the first edition.

The City Editor of *The Daily News*—who fluttered my modest heart by flatteringly inferring my right in the noble succession of Bagehot and Withers—found one fault with the book, that it dealt too briefly with the new Bank Return. That fault I have now endeavoured in some small measure to remedy. The new form of return made its appearance when that portion of my original manuscript was practically complete. I am able now not only to expound it briefly, but also to offer some timid criticism.

A section of the work which aroused a considerable interest with the general Press was that dealing with what I have christened "Parent and Offspring Finance." *The Observer* gave the great weight of its influence to my plea for some legal attention to what has been, undoubtedly, an open scandal in financial practice, and supported that plea by an apt example. *The Manchester Guardian Commercial*, through its Stock Exchange contributor, also agreed in general principle with my own view, but suggested that I had overlooked the effect upon post-war practice of the growth of tariffs. That aspect I endeavour, in this edition, very briefly to discuss.

One phase of contemporary financial practice did not receive sufficient attention in the previous edition, but has its place in this volume. The question of unsound underwriting I treat as a reform of the future, rather than as a fact of the present, because I believe it to be a problem with which the City must quickly grapple. The real significance of the prevalence of weak underwriting is not

that there were men of straw ready in the abnormal times of 1928 to assume financial responsibilities for which they were in no sense equipped, but that promoters, issuing houses, and original directors do not always realize the full measure of responsibility which they themselves tacitly undertake by their selection of underwriters.

In conclusion, I would again solicit the understanding, if not the sympathy, of my readers for the scope of this work. It pretends to be little more than a primer, the mastering of which will not absolve the student from the task of reading specialized works on the individual phases of the general subject; but it also aims at two other objects besides primary instruction. Those objects are the collation and criticism of financial, economic, and sociological tendencies as they affect the work of all who have in any way to handle finance, and the dissipation of the mystery myth to which much of the first chapter is devoted.

The understanding of finance, whether commercial or national, is a first duty upon the enfranchised citizen. It can be attained without undue pains and it is the monopoly of no one class or type. The pilgrimage towards complete mastery which in this book I inaugurate and try to conduct should be entered upon in the spirit of Dan Chaucer and not that of Henry II being whipped forward to the tomb of Becket. A man must be deadly serious about finance when he handles it in the concrete, but there is no reason why he should not be flippant occasionally when he is handling finance only in the abstract. Finance can be very fascinating, and some financiers of my acquaintance are positively funny. It is significant, in this regard, that the Stock Exchange is the mint of the best, if not the most printable, of stories, and that Throgmorton Street is a place of easy laughter and

high spirits. If readers of this edition find, as many of the readers of the first edition say they have found, that what has seemed a grim subject can be made, without any loss of learning, amusing and entertaining, I shall be very well satisfied.

C. B.

January, 1930

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INTRODUCTION

THIS book does not pretend to be an exhaustive treatment of its title. Such a treatment would occupy many such volumes. But while the work cannot, without affectation, be called a mere elementary primer, it is to the full professorial treatise as a friendly barrack-room lecture by the Sergeant-Major compared with an exposition by the Commandant of the Staff College.

The purpose of the book is to provide, for the student of any of the financial professions and for the general reader, a first survey of the terrain of which the specialized territory of the accountant, the banker, the company secretary, the business executive, or the private investor forms a part.

I have used generously, and without scruple, many first and second authorities on various phases of finance, and have endeavoured faithfully to acknowledge my borrowings. I have also adapted to my use many talks with practical financiers. A list of writers and others to whom I am indebted would be too long a catalogue for comfort, but I wish to make general acknowledgment, and I include in the book a short bibliography which is itself a confession of my various debts.

Most textbooks are arid and uninviting in their mode of presentation. In the gallant hope of avoiding such aridity I have chosen to write this book with a reasonable respect for the canons of English prose, but with a deliberate use of colloquialisms and the first person singular. I have avoided the use of actual names of persons and companies when I wished to present an example, and have substituted imaginary names. It

was no love of facetiousness, but fear of causing offence, which dictated such names to my pen.

There is some amount of repetition in these pages, but, since it is deliberate, I refrain from apologizing for it. A work which endeavours, however broadly and superficially, to outline every phase of financial theory and practice, cannot avoid treating the same operation from different angles at different times. There is also much which borders on the controversial. I have made a very honest endeavour to avoid expressing my own views on vexed questions, except where I have stated a heresy for the special purpose of damning it; and when in some sections general economic questions obtrude themselves, I have equally endeavoured not to give rein to my personal and partisan convictions and emotions.

C. B.

June, 1929.

THE THEORY AND PRACTICE OF FINANCE

CHAPTER I

FINANCE AND FINANCIERS

About any organized activity of mankind there gathers in time a mass of superstition. By superstition I mean, in the exact words of the nearest dictionary, " excessive reverence or fear . . . belief in what is absurd, without evidence." It is fostered always by the coincidence of two kinds of vanity, the vanity of the practitioner, who, quite naturally, wishes his own mastery to be mistaken for a god-like command of supernatural faculties, and the vanity of the ignorant, who wish their lack of knowledge to be excused on the grounds that, by some divine ordinance, wisdom is not obtainable through the normal exercise of normal intelligence applied to the activity in question.

Organized religion has always suffered in this way. Until the years between 1914 and 1918, war and its practice was regarded by the mass of civilians with the same " excessive reverence or fear." Until the effects were felt of the Education Act of 1870, augmented by the rise of the " popular " and " intimate " Press, statecraft was similarly regarded. At this time finance is still so regarded.

Superstitions About Finance.

Unfortunately the superstition which has surrounded the organized activities of mankind has been of two

kinds. There is the superstition that the activity is a mystery to be understood only by the favoured elect. There is the superstition that one particular gift gives mastery immediately over what is in reality a collection of distinct and individualized activities, grouped under one generic name only for the convenience of indicating their similarity or interdependence.

Thus, for example, the urban dweller speaks of agriculture as if it were one industry, whereas the agriculturist knows it to comprise many. The demagogue talks of a "business government," as if business were one activity, whereas the business man knows it to be many activities, the pursuit of which demands many different types of mind and training. The ordinary person talks of finance as if financial theory and financial practice demanded only one type of brain for their complete mastery, and that type a rarity. A prevalent superstition, apparently shared by Mr. Rudyard Kipling in his more mystic moments,[1] is that while the Gentile may, by fasting, prayer, and assiduous study, master the mystery of finance, the Jew inherits an instinct which gives him such mastery from birth.

The Mystery Myth.

It is essential that the student of finance should from the beginning clear his mind of the cant that the subject demands for its mastery anything but a normal intelligence, a reasonable application, a retentive memory, and some knowledge of elementary arithmetic. It is obvious that if a mind be equipped with special faculties, or have some ordinary faculties developed in an abnormal degree, the study of finance will be easier and its mastery more rapid. It is also obvious that what one may loosely

[1] See "Song of the Fifth River" in his *Songs from Books.*

call the stupid mind will never be able first to grasp and then to retain the principles of finance or the details of their application. But the mind which has proved equal to the tests imposed upon it by, say, the examination for Matriculation or for the School Leaving Certificate, will find in the study of finance no undue strain upon its general capacity. Upon the title page of any such book as this might truthfully be written the words "Nothing is here for tears," and those complacent citizens who boast with pride that the financial pages of a daily newspaper are Double-Dutch to them are, in reality, confessing to nothing more serious than a lack of interest in the peculiar "shorthand" by which is conveyed daily news of the shifting and changing economic relationships of the human family.

The mystery myth, carefully fostered in different ways by those who understand finance and those who do not, and particularly cultivated by financial journalists (like myself) who wish to keep a scarcity value upon their work, need not, therefore, be taken too seriously by anyone who approaches for the first time the study of the many associated activities which collectively we call financial practice, and the historical and economic investigations and deductions which form the bases of financial theory.

§ 2

The word finance is itself a little ambiguous. It is used in several senses. In the early stages of this book it is used as a synonym for "money affairs." In the later stages it will be found to mean the administration and management of public money, either in the sense of money contributed by the public for national purposes or lent by the public for private, that is industrial, purposes.

The Treatment of Finance.

Finance may be treated in any one of three ways. It may be regarded as a science, as an art, or as a business. As a science it is, and must necessarily remain, inexact, but none the less our knowledge can be arranged under general truths and principles, and various processes can be examined and analysed. When theories of currency and of foreign exchanges are reached it will be found that a strictly scientific method can be applied, and that scientific conclusions can be reached. These conclusions become rules by which the practical skill of financiers can be guided. The financier as artist is he who applies such rules in such a way that his direction and control of finance have a definite constructive and unifying purpose, as contrasted with the series of expedients by which business finance very frequently proceeds. These three methods of financial application give us in practical life three distinct types of financier, performing three quite distinct functions, with the accountant intervening as the critic of the performances of each of them.

An Inexact Science.

It is essential that the student should realize that the practice of finance at any stage of the financial history of the race—even during the past hundred years—has always been subject to the disabilities which afflict any inexact science. Under the stress of economic circumstances men have both departed from precedent and challenged the deductions which their forerunners have made from earlier experience. While it is true to say that there is something which the learned can identify in any given circumstance as "sound finance," it is not true to say that a new departure in the application or control

of money or credit can immediately be classified as "unsound finance."

It has been said in another connection that history knows no such thing as an unsuccessful revolution, since a revolution which does not succeed is not a revolution, but merely an abortive revolt. The history of finance knows no successful revolutions: it knows only accelerated evolution. Any departure from financial precedent which has been made, whether successfully or unsuccessfully, or any new deductions from old facts challenging previous conclusions as fallacious, have not radically altered the conduct of men with regard to their money, although changes in the conduct of men have frequently altered the application of old truths and new truths about money and its uses.

The Need for the Financier.

There was a time, as will be seen later when the history of money is discussed, when the economic life of a community was so conducted that there was neither a need for nor a supply of men whose concern was not with the business of offering goods or services but with the business of placing in touch those with goods or services to offer and those with the means to command them. The money affairs of such communities were entirely controlled by men to whom money was still a personal property. A modern community could not continue to exist in all its complexity if the old simple conception of money prevailed. We have therefore evolved a special type of functionary whose work consists in making coincident wants and their satisfactions. In a primitive community three men might have three bullocks standing idle while a fourth man urgently needed three extra animals to plough his land. To procure the loan of the

idle bullocks he would himself visit their owners and arrange the necessary bargains, guaranteeing and arranging the return of the animals to their respective owners. To-day the discovery of a piece of territory which could well employ extra facilities of cultivation, and the knowledge that such facilities existed but stood idle, would call into activity an extra man, whose business would be to arrange the application of the facilities to the land which could profitably employ them. Such a man might be called by one of several names, but he would be in effect a financier. The place of finance in modern life and the function of the financier is, in brief, to make coincident known or suspected wants and the means of their fulfilment. That the intervener may be inspired merely by a desire to take for himself some of the fruits of the satisfied want, or to share the benefit of the bargain which the owner of facilities makes for their loan, does not affect the fact that his intervention is beneficial to all concerned in the act of using profitably means of production which, without him, might lie fallow or, at best, would not be so fully employed.

Unconscious Functionaries.

The results of a human transaction cannot be judged by the motives of those who engage in it. The economic value of modern financial practice cannot be gauged from the indubitable fact that many men are vastly over-remunerated by the community for the performance of the function of making want and means of satisfaction coincident, or from the equally patent fact that some men create imaginary wants and imaginary means of fulfilment and, on the plea of rich rewards for making them coincident, attract to themselves the property of simpler members of the community. Still less can the

value of the modern financial system be appraised from the economic self-consciousness of those whom it employs, or who employ it. Many a financier is as unaware of his true function as is the earthworm, which plays a valuable part in a natural system of irrigation, or the bee, which in its quest for the means of its own subsistence makes coincident the want of a flower for fertilization and the means by which it is fertilized. I stress this matter before beginning the real work of this book because so many minds are either repelled from the study of finance, or, when engaged upon such study, fail to relate it to daily life, because of a superstition which is prevalent not about finance but about financiers. Thoroughly to grasp the essential principles of finance, and to enjoy the fascination and mental fulfilment which financial practice offers, it is necessary to approach the financier not in the mood of the caricaturist but of the religious mystic. The man must be separated from his " office." I propose, in a final digression to this introductory chapter, to note a somewhat striking paradox in modern public life, in order to prevent an uneasy feeling later, that our discussions of the various phases of finance have become so academic that they have ceased to bear any recognizable relationship to the realities of life as we all know them.

Judgment and Misjudgment.

The paradox which I note is that the minds which habitually refuse to separate the " office " of the financier from the personality of the financier are those minds which refuse to relate the personality of the actual producer of commodities with the " office " he fills under the State. We are all familiar with political lampoons in which a worker is shown in juxtaposition with a

capitalist or a financier. The worker is invariably depicted as a noble ascetic deprived of the legitimate fruits of his toil by the bloated and cunning parasite beside him. The implication is that the producer (or distributor) of wealth by filling a noble function attains himself to nobility, while the capitalist or financier by filling a parasitical function acquires all the most revolting characteristics of the parasite. Almost equally familiar is the conception of the financier as a pompous and stupid person whose concentration upon money has robbed him of all human virtues. Mr. Humbert Wolfe has enshrined this conception in a poem which has been seized upon by compilers of anthologies as an adequate expression of the genius of the poet and the fatuity of the representative financier. The first and last verses of the poem run thus—

The City Financier
walks in the gardens,
stiffly, because of
his pride and his burdens.

He looks importantly
about him,
while all the spring
goes on without him.

As a matter of hard fact the producer (or distributor) of wealth may be, and often is, a stupid sot, given to over-indulgence in strong drink, with a weakness for wife-beating, and with little value as a citizen once his work of minding a machine or digging a trench is over for the day. The capitalist and financier may be, and often are, persons with a most lively interest in the cultural activities of mankind. Walter Leaf, translating Homer, or Lubbock, agitating himself about the beauties of Nature, may not have been representative financiers,

but they were quite as representative as Mr. Wolfe's pompous ass or as the bloated abomination of the political cartoons.

The real point at issue is, however, that *qua producer*, the drunken cotton operative misconducting himself in some obscure alley way in Oldham, instead of studying Ruskin's " Unto this Last " like his glorified prototypes on the posters, is a valuable unit of the economic community ; and, *qua financier*, the fat, stupid, pompous, heartless, and oleaginous gentleman displaying his shiny silk hat and " gent's gold Albert " watch-chain to the birds in Kensington Gardens and the scorn of Mr. Humbert Wolfe, is also a valuable unit of the economic community : and the study of finance is not designed to enable a tyro to compete with the experienced players of some kind of round game in an endeavour to deprive the creators of real wealth of their hard-earned property, but is designed to render intelligible the significances of a very vital phase of economic relationships.

CHAPTER II

MONEY

THOSE who share with the Rt. Hon. Stanley Baldwin, Mr. Gilbert Chesterton and myself, an antique fondness for the works of Charles Dickens, will recall with affection the grotesque figure of Mr. Chadband, of whom I am now compelled to give a slight impersonation. Mr. Chadband, it will be recalled, having sated himself upon the viands of Mr. Snagsby, laid his hand upon the head of Poor Joe and proceeded to address to him a series of rhetorical questions. I now, metaphorically, lay my hand upon the head of the nearest available reader and break forth in the same rhetorical strain.

"What is Money?"

"My young friend"—you imagine me to be saying—"What is money? Is it a beast of the field? Is it a bird of the air? A fish of the sea or river? Is it a stick, or a staff, or a stock, or a stone, or a post, or a pillar? Is it pounds, shillings and pence? Or pieces of printed paper? My young friend, what *is* money? Let us, in a spirit of love, inquire."

At the end of such an inquiry we shall find no one definition which is at once succinct and adequate, but for the convenience of those who wish to embark upon the investigation with the goal already known, I will lay down here, dogmatically, three definitions generally accepted by economists.

The definition of the term money, framed by Karl Helfferich, is as follows—

> *"We understand by the term 'money' the complex of those objects which in a given economic area and in a given economic system have as their normal purpose the facilitation of economic intercourse (or the transfer of values) between economic individuals."*

Professor Henry Clay, without precisely formulating a definition, regards money as—

> *A generally accepted medium of exchange which is also a standard of value.*

Professor Cannan, wisely denying that money and other economic terms can be successfully defined in a few words, since their meaning varies according to context, frames the following definition for use in a context which concerns itself with the relationship of money to the phenomenon of price changes.

> *"'Money' means the unit of account commonly used in purchases and sales and other commercial transactions."*

It will be noticed that these definitions have one feature in common. They do not define the nature of the substance of money, but its functions. In setting ourselves to answer the question "What is money?" we cannot do better than adopt the methods of earlier inquirers and begin by an examination of those functions and the manner in which they have been performed, and have grown, through the ages.

The Functions of Money.

When the schoolboy receives his pocket-money, the workman his wages, and the professional man his fee, what do they actually receive? In this country they receive a number of coins or a number of slips of paper specially printed under the authority of either the State or the Bank of England. For what reason do they receive these bronze and silvern medals or these slips of

highly decorated paper? They receive them in return for services rendered. Those services differ enormously in kind and in value. The schoolboy has done nothing for the community, broadly speaking, except survive the perils of birth and childhood and enliven, by his mere being, the home which houses him. The worker has helped to produce commodities without which the community would either perish or fall into barbarism, or he has made possible the transport of such commodities from the place of their production to the place of their consumption. The professional man has helped to make easy and pleasant the communal life of his fellows, either by providing certain decorations, such as paintings, novels and plays; or by preventing relationships from becoming too tangled, which is the function of the lawyer, the banker, and the accountant; or by providing instruction which helps his fellows to live a richer and more satisfactory life, which is the function of the schoolmaster, the doctor, the preacher, and the writer of textbooks of finance.

A Medium of Exchange.

Having rendered the particular service demanded of him, or which he has been able to force without demand upon the community, and having received his medals or his slips of paper, what use does the recipient make of his money? He does not, if he be a normal person, use the medals for decorating his attire and the printed slips for papering the walls of his house. Nor does he evince any desire to retain them in his possession. Having received them, his first and constant care is to part with them. But he parts with them only for a return, and that return is the use of the services of his fellows or the use of some commodities made available by the

services rendered by his fellows in advance of his making a specific demand upon them. The money he receives, in short, enables him with the minimum of trouble to exchange whatever service he is able and willing to render for whatever services he demands from those about him.

The Problem of Inequality.

It will instantly occur to anyone who studies, however superficially, the constant exchanges of services which make up our daily life together that some men and women are able, from reasons which we will not examine at the moment, to extract from those about them services greatly in excess of the service they themselves render, and that others render services greatly in excess, either in terms of energy or "value," of those they receive in return. Some persons even seem to extract services without themselves rendering any return in kind. As the average man phrases it, some men are over-paid and some men are under-paid. Some men get too much money and some men get too little money.

This is but another way of saying that, whereas money is obviously and beyond dispute a means of facilitating an exchange of services (in which word for the moment I must, for convenience, include the commodities which are procured by services), it is not always obviously and beyond dispute a standard of value.

Direct Exchange or Barter.

This is not sound reasoning. If man receives what in the opinion of an onlooker is too much money for his services or too little money, as the case may be, the fault is not in the value of the money. The fault is in the scale of values which we have placed upon the services

exchanged. Let us suppose that money, as we know it, does not exist. Let us also suppose that we are members of a small community which consists of a farmer, a boot-maker, a baker, a barber, a parson, a comedian, a publican and some others, whose trades need not worry us. The farmer has for disposal a pig, some potatoes and a few cabbages. The boot-maker has for disposal three pairs of boots. The baker has baked twenty loaves of bread. The publican stands at the door of his inn ready to welcome any customer to its shelter and to serve him with drink. The farmer, under domestic pressure from his wife, desires to have his hair cut and his beard trimmed. If the barber happens to want potatoes, a bargain may be struck under the terms of which an agreed number of tubers is given for the barber's services. The farmer also wants a new pair of boots. By another bargain he obtains them from the boot-maker for the same number of potatoes which he paid to the barber for a hair cut and a beard trim. Later in the day the boot-maker also decides to have his hair cut and his beard trimmed. By a private bargain he gives a pair of boots to the barber for his services. At this stage the arbitrary values set upon services and commodities in that community, as we know them, are easy to compare. X potatoes are worth a pair of boots or a hair cut and beard trim. A pair of boots is worth X potatoes or a hair cut and beard trim. A hair cut and beard trim is worth a pair of boots or X potatoes.

But later in the day the publican, having bargained in private with the farmer, is able to offer to his customers a meal of roast pork, cabbage, bread and potatoes. To this meal our farmer, baker, barber and comedian, sit down in amity. Each has bargained with the publican. The comedian gets his meal in return for singing, when

it is eaten, one or two songs. The boot-maker gets his meal as one of ten such meals in exchange for a pair of boots. The barber gets his meal as payment for an agreed number of hair cuts and beard trims which the publican is to have on demand. The baker gets his meal in exchange for five of his loaves.

It occurs to the kind-hearted publican that the parson may be hungry. He therefore sends over to the parsonage, between hot covers, a meal of roast pork, cabbage, bread and potatoes, with a message that it is in return for the benefit he derived from last Sunday's sermon. Moved by a similar impulse, the baker has already sent to the parson a freshly baked loaf, the farmer has dropped at the parsonage half as many potatoes as he gave for his pair of boots and his hair cut and beard trim, and the bootmaker has made for the parson a pair of boots. The comedian, being a Godless fellow, thinks that the parson deserves to starve for preaching against comic songs. After the meal, however, the mood of the diners has changed, and the comedian by his buffooning moves them all to high appreciation. The barber offers to cut his hair for nothing. The farmer gives him the last of the cabbages. The baker tells him he may call on his way home and have a loaf of bread. The publican gives him what is left of the now cold pork.

Changing Relative Values.

By this time there is no apparent scale of values left by which to measure the exchanges of this small community. By any rigid and exact scale the parson has been grotesquely overpaid for his sermon. In bargaining for the dinner neither the barber nor the bootmaker has considered what the other is giving in comparison with what each has given the other earlier in the day for

their mutual exchange of services. The services of the comedian, which were originally considered worth one meal, have undergone an appreciation, and are found by him to have been worth one meal plus a hair cut, plus a loaf of bread, plus a cabbage, plus some cold pork. Nor has the farmer any guide in his day's transactions to what he may receive the next time he comes amongst his fellows with a pig, some potatoes and a few cabbages.

How Money Supersedes Barter.

Our imaginary circle of people has conducted its operations without the aid of money. It has used the method of barter. (For the benefit of those who may desire to have an accepted definition of the term: Barter is a means of traffic by the direct exchange of commodities.) Had there been a prearranged agreement, our friends might as easily have conducted their operations with the aid of money. They might have agreed to measure all exchangeable things by the value of a potato, deciding that a hair cut and beard trim was worth a dozen potatoes, a pair of boots worth four dozen potatoes, a pig worth a hundred potatoes, a sermon worth one potato from each auditor, a comic song or two worth three potatoes, and a meal in the inn worth two dozen potatoes, and so on. The potato would have been their money—inconvenient in form and suffering other and grave disabilities for the performance of its function, but, still, money. It would have been, perhaps, a temptation to the parson under such operations to complain that the services of the comedian were over-valued, since for singing two or three songs he received a free meal worth two dozen potatoes. The comedian might legitimately say that had he charged the publican and his customers each the three potatoes usually given as

an admission fee, he would have received not two dozen but only fifteen potatoes, and that therefore his admission fees must be too low, and would in future be raised to four potatoes. But if any of the small community said that the potato was itself no standard of value, he would confuse cause and effect. In saying that the comedian received too many potatoes for his services, the parson would in effect be saying that the comedian's services were not worth, by the parson's standards of value, the services rendered to the comedian by other members of the community. He would not be saying that since he received only half the number of potatoes for services worth twice the communal return of those rendered by the comedian, therefore the potato were either no standard of value or were a fluctuating standard. The potato would be a fluctuating standard of value only if the number of potatoes produced each crop differed wildly from one year to another. That aspect of money we shall discuss in due course. The point to be remembered at the moment is that money used as a medium of exchange is a standard of value, even if the values exchanged seem to the exchangers or an onlooker to be wrongly valuated.

The Convenience of Money.

Money is not only a medium of exchange: it is a convenience of exchange. Professor Henry Clay in his *Economics for the General Reader* has said, in words which for lucidity and truth certainly cannot be bettered by any words of mine—

> "The direct exchange of goods we call barter, the indirect exchange of goods, through some medium, we call buying and selling. Barter is impracticable as a rule in a modern society, since it involves what has been called a 'double coincidence of wants'; under a system of barter, the barber who wants bread

has to find not merely a baker but a baker who wants his hair-cutting, the baker who wants his hair cut must find not merely a barber but a barber who wants bread. Even when two people who want each other's services have come together, they may be unable to agree as to terms; the baker may consider two quartern loaves a fair equivalent to three hair cuts, while the barber demands a loaf each time he cuts the baker's hair. The degree of specialization which characterizes modern industry could never have been reached under a system of barter; it is too minute, too complicated, too extensive both in space and time; the increasing use of money was both sign and cause of the transition from the primitive to the modern economy."

Every one is aware, from the growth of his personal habits, how rapidly and completely a mere convenience can grow into an essential. The convenience of exchange which is furnished by money has long since become such an essential, as a passage from Sir Ernest Benn's *The Confessions of a Capitalist*—written to illuminate a somewhat different complexion of exchange—admirably indicates.

"Take, for instance, the collar that you are wearing, and examine it closely. What is it? How was it made? You will find that you bought it in the Strand, London, for a shilling; that it was made in Leicester, with machinery, some of which came from Manchester, some from the United States, and some from Germany; that it is composed of Irish linen manufactured in Belfast from flax grown in Russia. So within thirty seconds you have travelled round half the world; you have been brought up against the problems of iron, steel, coal, transport, and power, and, most wonderful and complicated of them all, credit banking and finance.

"When you pause to consider that in some miraculous way a part of your shilling which you paid in the Strand for the collar you are wearing, operates to provide the peasant in Russia, who reaped the flax from which the collar is made, with a cup of tea from China or a cigarette from Cuba, you get an elementary insight into the complications of this thing called 'wealth' . . ."

You also get an elementary insight into the convenience of money as a means of exchange. Your shilling has

given you a call upon the services of Leicester collar makers, Manchester, American and German engineers, railway workers and sailors and stevedores, Russian peasants and Irish weavers, London shopmen, and a variety of other workers. You have had no need to find a flax grower or a collar maker desiring the particular service which you, yourself, render to the community, nor have you had to bargain with an Irish linen manufacturer as to the exact amount of your own service, or of the commodity which you produce, which equals in value the amount of linen needed to make you a collar. The shilling has, by the magic of money, simplified innumerable searches and bargainings into a single and monetary transaction, as the kopec which the Russian peasant received for his share of the complicated series of exchanges simplified for him a similar complication of searches and bargainings which would otherwise have stood between him and the slaking of his thirst for China tea.

Barter in Modern Life.

So great a convenience to exchange is money, that it is difficult for the modern mind to conceive a state of society without it, although sections of modern society still continue to effect exchanges of goods and services by simple barter. Schoolboys with their primitive "swops" are quite as accustomed to barter as to buying and selling, and once during the war I was reduced to a similar primitive barter, and made a direct exchange of my services as a relatively facile roller of puttees for the services of a friend who was an adept at stropping an old-fashioned "cut-throat razor"—one winding of puttees being agreed to equal three stroppings of a razor. Anyone who had the misfortune to act as Mess President

to an infantry unit on active service will recall how adept mess caterers became at bartering bully-beef for eggs, and ration tobacco for civilized cigarettes. But, in normal times, we have grown so to rely upon money as an aid in our dealings that in order to discover its origins we are compelled to retrace the history of the race back to the most primitive economic conditions, for otherwise we are in danger of regarding as a state of affairs responsible for the creation of money a state of affairs which was made possible only by the existence of money. In some stages of history it is impossible to say with certainty whether the existence of a particular set of conditions and relationships led to the use of some form of money, or whether the use of some form of money made possible such a set of conditions and relationships.

§ 2

Since historians quarrel about history, it is not surprising that about pre-historic conditions they fail to reach unanimity. We have no real concern here with the question whether the first men to inhabit Europe were or were not the Cro-Magnards, which race has been imaginatively reconstructed from the skeletons of the Cro-Magnon cave, and we need not worry about the interesting discussions which wage round the grim figure of the Neanderthal man. Some authorities have pictured for us a race of cave-men, conducting their wooings by means of knobkerries, and at least one authority has reminded us that all we know of the cave-men is that they made wistful attempts to decorate their caves with what was quite obviously a yearning towards the aesthetic. Whatever be the truth about cave-men, we are fairly safe in assuming that despite some efforts at civilization

they were savages, and that primitive societies differed little in their modes of intercourse. They pierced shells for ornaments, they decorated their bodies with colours, they made rude drawings by scratching on bone and rock, and they gradually increased the number of their crude implements. They clothed themselves with skins and they mastered the art of basket making, but they did not cook, and they most certainly conducted their simple exchanges of services and commodities by means either of barter or seizure.

Exchange by Seizure.

It may seem something of a contradiction in terms to talk of exchange by seizure, but if we pause to examine a few savage transactions, the justification of the phrase will be apparent. Agag—that hairy, primitive warrior—desires ardently the shield of Gaga. He may make overtures to its owner, and proffer in exchange for the coveted shield a very good spare wife for whom he has no further use, or he may offer to decorate the cave of Gaga with one of his pleasing drawings of a little horse. Alternatively, he may arrange an ambuscade, and with a piece of rock fell the passing Gaga. Choosing the second means of securing the desired shield he obtains it with, apparently, no return of service, unless the stricken man is prepared from the Happy Hunting Grounds to regard his dismissal from life as a service worth its cost. But the taking possession of commodities by seizure is not a method personal to Agag. It is common to the tribe. In due course the son, or friend, or chief wife of the stricken Gaga, will covet the wolf-skin of Agag and apply similar primitive means of transfer. Over the collective history of the tribe these recurring incidents can fairly be described as a means of exchange by seizure.

But both barter and seizure, as we have seen, become inconvenient when the number of persons desiring to exchange their services and commodities increases. It is also to be noted that if early settlements of men were strictly communal in their relationships—if, that is to say, possessions were owned in common—there would still be the need for either barter or coercion in order to effect the application of individual skill and energy to the communal use and benefit. That men were ever communal is hotly disputed, but granted the fact—for the sake of speculation—we are still compelled to realize that they had at least one incentive towards discovering something in the nature of money in order to facilitate the business of rewarding the active or stimulating the sluggish member of the commune, since the abstract rewards which some theorists suppose might satisfy modern men under communism, could not have satisfied primitive man.

Pacific Intercourse.

Adam Smith was inclined to think that barter was one of the inevitable consequences of the faculties of reason and speech. Simmel, in his *Philosophie des Geldes*, has found in it an almost metaphysical significance, since it is, to him, " the first, and in its simplicity truly wonderful, means for the reconciliation of justice with acts of change in ownership." The discovery that barter could leave two covetous persons each in possession of something coveted without either being subjected to violence actually led, from this point of view, to the beginnings of pacific intercourse and civilized relationships between men conscious of a sense of ownership in property.

In the communal tribes—if any such ever existed—

the impulse to barter would arise from the moment that there was established an external relationship with some other body of living men. A communal hunting people encountering a communal pastoral people, or even a similar hunting people, could expropriate by violence or by barter. A variety of circumstances, the state of activity or lassitude in the fighting men, the weather conditions at the time of encounter, the nature of the terrain on which the encounter took place, a misconception as to the prowess of the larger numbers of pastoral people by the smaller number of hunting-fighters, would lead in isolated cases to a recourse to barter, and the habit once contracted would tend to remain.

The Money-sense.

In the centuries before the seventh century and sixth century B.C., the trade of the world, as far as can be judged from very inadequate data, was almost wholly conducted by primitive barter. But the money sense had here and there been awakened, and the use of money had been discovered.

There was, of course, no coined money. What had happened was what we imagined might have happened to our hypothetical little community which gathered in the inn to consume its meal of roast pork, only, instead of the potato being made the rough standard of value, cattle had been seized upon as a possession which could be used as a means of exchange and a measurement of the things exchanged. Cattle remains to these days the effective money of some of the African tribes. Certain peoples inhabiting seaboards used, we are led to suppose, not cattle but particular kinds of shell, and others living in lands where cattle did not flourish used as their money a particular variety of nut. It must be thoroughly

understood that in making these assertions about the early tribes of man we are asserting only a speculative conclusion. The records are neither adequate nor exact enough to justify too dogmatic a statement. But we do know that Homer in the *Iliad* speaks of the value of shields in terms of cattle, and we also know that primitive communities surviving into recent times have used as money such objects as slaves, glass beads and oxen.

It must not be supposed that the money sense and the use of money—whether in the form of cattle, slaves, shells, or later, coined metals—caused a complete and rapid transition from transactions by barter to transactions by buying and selling in terms of the agreed money. Clare and Crump in their *A.B.C. of Foreign Exchanges* use as an example of foreign trade a passage from the Old Testament which is, incidentally, a reminder that as late as the days of Solomon huge exchanges of commodities were being arranged and conducted on terms of pure barter. The passage will be found in 1 Kings 5, viii–xi, and is worthy of study.

Two Discoveries.

In arranging their exchanges the earlier human societies, then, discovered two things. They discovered that barter was inconvenient, since the wants of one man or one community at any given time might not coincide with the ability or readiness of another man or community to supply them, or with a want in the other party which the tradeable possessions or services offered would satisfy. They discovered, also, that in every community there were certain objects which were always in demand and always of use. A man or a tribe might not be ready to trade skins for corn—having too

few skins and already enough corn; or give corn for skins—having too little corn and too many skins. But cattle and women were always acceptable, and gauds always attractive. Any man having surplus women or surplus cattle could be fairly sure that if he offered them to a neighbour with an overplus of some other commodity or with some special ability, he could obtain what he wanted in exchange. Our friends Gaga and Agag of a new generation, having shed their fathers' fondness for ambuscades, might meet, and Gaga might suggest to Agag that he would hand over two fish in return for Agag's help in the fashioning of a flint axe. To this offer Agag might well reply that he was already tired of the taste and smell of fish, having himself a glut of that food, and knowing all others in the tribe to be equally sated. But if, for the promise of help on various occasions, Gaga offered a calf, Agag would know that, if he did not himself desire a calf, he could quite easily trade it off with Yobo for the pelts he did want, since no man could have too many cattle. He would, in other words, know cattle to be generally acceptable—which, as we have seen, is one of the essential qualities of money.

By experience of many deals he would also know, roughly, what various members of his community would give for a single animal. That is, he would regard the beast a standard of value. Being generally acceptable and having a known value, the beast would be an effectual piece of money.

Cattle Wealth.

In a very short time Gaga, Agag, Yobo and their like would not trouble to offer individual commodities or to seek special exchanges. They would offer services and

goods in exchange for cattle and offer cattle in exchange for services and goods. It is worth noting at this stage that the very word for money in Latin is *pecunia*, which comes from *pecus*—cattle. It survives in our own tongue in the familiar phrase, with which we are most of us too well acquainted, "pecuniary liabilities." It is also to be noted that cattle formed in early communities the actual wealth of the tribes. When cattle were used as money, an actual transfer of wealth took place. We shall see later that more modern forms of money sometimes transfer actual wealth in the same way, but as often transfer, not wealth, but a mere call on wealth.

§ 3

The use of a single commodity as a means of testing the value of all other commodities in exchange, and as a means of simplifying complex bargaining, was a great advance upon barter, and a still greater advance upon violence. But it cannot have been long before trading men discovered that they had more forms of wealth than one, and that some of these forms were more easily transferred than others. An ox had certain advantages. It had not to be carried to its new owner. It also had the defect of its quality. It could not be put into a dug-out canoe and ferried over a stream. Also its value in relation to the things for which it was and could be exchanged was far from stable. Cattle bred. They also died. They were consumed. An ox also had the advantage that even if it died, or was consumed, something of its value remained. It yielded a hide and bones and fat. When accepted it was not a sterile possession until exchanged again for something else. It could be yoked to service.

Mystical Properties.

Other commodities came into use. Tobacco and bottles of gin have been, and are still, in some places, regarded as legal tender in certain societies. Each commodity used had its special merits. Some were imperishable. Some were easily portable. Some were fruitful between exchanges. Some were even credited with mystical properties. Helfferich has an interesting account of some examples of savage mysticism in regard to money.

> "Extraordinary results," he writes, "have arisen from the connection between mystical conceptions and money in the minds of certain semi-savage races. Rarity of sources of supply, antiquity, the bringing of the money from distant parts accompanied with definite ceremonies, some sort of connection between money and the cult of the dead and the belief in ghosts—all these have frequently brought it about that semi-savage races clothed certain commodities, in themselves useless, with a mysterious dignity. Thus the extraordinary glass and enamel money of the Pelew Islands derives its value from its antiquity and the belief in its supernatural origin. The stone money of the island of Yap, which consists of millstone-like slabs of aragonite of varying sizes, is imported under conditions of great danger from the Pelew Islands. The inhabitants of the Bismarck Archipelago were in the habit of fetching their shell money at definite times from certain parts of the north coast of New Pomerania."

Of all the commodities which have served primitive societies as money, one category from the first made the strongest bid for permanency and domination. Articles of adornment or substances which could be made into such articles had always a double appeal. They were always acceptable and generally portable. Their only disadvantage, as a rule, was that between exchanges they were sterile outside their function as adornments, although this was not always so. Rare and precious stones, curious shells, and the precious metals began to oust more bulky forms of wealth from the money function.

Iron Discovered.

The Hittites discovered a means of extracting iron from ore. It became an exceedingly valuable substance. Aristotle speaks of it as supplying the first currency, and Caesar in his account of the Gallic War is our authority for the knowledge that bars of iron of a known weight were used as coin in the British Isles. But iron was never as precious as gold or, perhaps, as silver. Letters of Amenophis III and his successor speak of iron as a valuable gift, but until the later dynasties in Egypt, silver was almost as rare and valued as gold.

§ 4

Once human communities had developed buying and selling, instead of barter, and a certain group of commodities was furnishing their means of exchange—that is, their money—the progress to some form of crude coinage was not long delayed or difficult. The relative value of a slave, or a woman, or a beast, compared with other commodities, was easy to fix and to grasp. But mere pieces of precious metal or mere shells had no such obvious fixation of value. The use of primitive forms of money still entailed a certain amount of bargaining in each transaction, just as the use of the most modern coinage in lands like rural Italy, or even rural England, still entails a certain amount of bargaining. In other words, a distinct medium of exchange, as opposed to a commodity of exchange, had not evolved. There were, too, some arbitrary customs which affected primitive forms and use of money. Slaves, for example, could not in some African tribes be used as money for the purpose of anything but specially valuable goods, such as ivory or weapons. Wives in other places could be bought only by the use of special forms of money.

As we have seen, there arose a habit of stamping pieces of metal with some indication of their weight. This was the first step. But a bar of iron used by an early Briton as money had still one great disadvantage even after it had been stamped with its weight, and its exchange value thus roughly fixed. It was difficult to transport. The tendency became ever stronger, as human relationships became more complicated and commodities and services greater in number, to use as media of exchange only those substances which were at once precious and easily portable. The more precious a substance was, the less of it had to be given in exchange for other goods. The less of a substance needed in exchange, the greater the convenience.

In Babylon and Greece.

About six hundred years before Christ, the gold-bearing country of Lydia, in Asia Minor, produced the first coins of which we have any record. These gold pieces were minted by Croesus, who has become proverbial as a synonym for the excessively wealthy. It is, however, highly probable that Babylon knew coined money before this time, and it is certain that letters of credit, promises to pay, in the form of clay tablets or parchment, were in use before the Lydian coins. By the times of the Greek civilization, coinage had become so common that coins of the smallest denomination were in general use. Wells, discussing the Athenians, says of them that they "had a range of exceedingly small silver coins, running almost down to the size of a pinhead, which were generally carried in the mouth ; a character in Aristophanes was suddenly assaulted, and swallowed his change in consequence."

It will be realized that there were some services and some commodities which were of such small value in

exchange that a small piece of some precious metal was too great a return. With the use of gold and silver and electrum, a mixture of gold and silver, grew concurrently a use of baser metals, of which, from the earliest times to our own days, copper was the favourite.

It will be important later, during our examination of the growth of credit systems, to retain clearly in the mind the significance of the passage from what we may call crude money to coinage. It affected for ever afterwards the trading relationships and habits of mankind.

We have seen, in very scanty outline, the progress from general commodities used as money to special commodities used as money. When the nature of precious metals is considered, the inevitability of this progress will be apparent. At the risk of some repetition it may be well to review the characteristics which made such metals the eventually obvious media of exchange. Considered as commodities they had the following advantages. They did not at any time glut a recipient, since in all times the passion for display and the desire for hoardable wealth have together made such substances acceptable to almost any limit not affected by a difficulty of storage. They were, in that regard, easy to store. Consumable commodities, like grain or tobacco, lose their value once the uttermost needs of the community have been satisfied, for not only are they perishable, but their storage is neither easy nor safe.

Social Status.

The possession of precious metals was and is an outward and visible token of social status, a thing dear to man's vanity. The withdrawal of such substances from potential consumption, in the sense of utilitarian use, to be used as money does not impose

much, if any, hardship. The withdrawal of oxen or slaves or wives or an edible commodity might do so, and exchange thereby be hampered. Considered not as commodities but as media of exchange, such metals were extremely durable. The normal influences of the atmosphere affect them little. Long immersion in water, long exposure to the air, burial in the ground, exposure to fire not of especially intense heat, do not to any appreciable extent diminish their value. Only by the deliberate application of selected chemicals can they be transmuted or dissolved. Rough usage or long friction affects them less than it affects other substances. They are consistent in composition and they are easily and infinitely divisible. Once divided, they can be with ease reassembled into a unity by the simple process of melting. The value of the divisions corresponds to their weight. They are malleable, and can be easily stamped with symbols either of weight or authority. They are relatively stable. The precious metals, being durable, accumulate. The additions made to existing supplies are thus small in ratio. The biggest addition of gold in any one year, for example, represented only 5 per cent of world supplies, and was estimated to represent only some 2½ per cent of the total of gold and gold articles. Following the ordinary law of supply and demand, which, I assume, is familiar to readers even of a mere primer of finance, gold is not much affected in value by such a small ratio of addition. Broadly speaking, if any commodity were suddenly increased to twice its normal total, its value would be halved. (In practice other factors might and probably would affect this result, but they need not detain us at this stage of our examination.) But an increase of only 5 per cent, in conjunction with a rising demand, does not result in any such dramatic change in value.

Other substances and commodities have many of the qualities of precious metals. Gems, for example, are rare, are portable, and are, many of them, not easily destructible. But they are neither malleable nor easily divisible, and once divided are not capable of reassembly.

Advantage of Precious Metals.

The precious metals had one other advantage over alternative commodities. They remained desirable by men whatever change took place in habits or forms of civilization. Oxen, which were of obvious value to pastoral and simple urban people, were of less value to a people able to apply to the ground new forms of cultivation, and of very greatly reduced value to people of a distinctly urban civilization with complex systems of manufacture. It would, for instance, be extremely awkward to receive an ox in one's pay-packet, or to pay him out at the pay-box of a theatre, taking one's change in pigs and chickens. Still more awkward would it be to receive one's dividends in the form of a drove of oxen. But the precious metals are as useful to-day in the industrial civilizations of Britain and America as they are in the agrarian civilizations of some parts of Asia and as they were in Asia Minor eight centuries ago. Lady Hoggenheimer, of Park Lane, adorns herself with gold much as the Princess Amasis did when she looked forward to meeting her suitor at the Nile revels. The gold wristlet watch of Captain D'Arcy of the Guards is donned with the same pride as was the gold bangle of the first Roman Centurion who landed from Caesar's boat on the Southern shores of Captain D'Arcy's native land. Gold and silver need no pasturage, and a modern man faced with primitive money would remember Jorrocks and cry, "Confound all money what eats!"

The use of metals as money, however, confronted the users with a new problem. The habitual user of cattle knew the value of an ox. The coast-line dweller knew the value of shells. The hunter and fighter knew the value of weapons. But the average member of the early societies did not, and could not, know the value of metals. Even when metals had been weighed, and the very process of weighing them with exactitude involved the services of a relative expert, and when the weights had been stamped upon the pieces, no ordinary man could be sure that each was pure gold or pure silver. The problem was partly solved by the custom of making the metals intended for use as media of exchange into bars or rings, each marked with a symbol of its weight and fineness, although for many years bars and rings unstamped served faultily the same purpose, the bars being weighed and divided as need arose.

The Coming of Coins.

Eventually the unwieldy bars and rings, whether stamped or unstamped, gave place to coins, those at Lydia, mentioned a few pages back, being little ovals of metal with a number of parallel lines on one side and a number of incisions on the reverse. Later came coins stamped with pictures, the head of a lion or the effigy of a god. Sometime in the fifth century both sides of coins began to carry an impressed picture.

The first coins were struck on the basis of a weight system. Others were struck after calculation of relative values, and it has been suggested that the name *pecuni* was given to coins because early specimens had contained an amount of metal equal to the value of the ox which had previously been the unit of exchange.

There is one important difference to be noted between

the coins of even the earliest date and the stamped or unstamped bars which preceded them. The bars were not equal one to another. Two bars of equal weight might not be of equal fineness, just as to-day two wedding rings of equal weight may be of different carats. But coins of the same denomination were and are equal one to another, and modern authorities are right in insisting that the concept which students of economics and finance form of a " coin " should include this factor.

CHAPTER III

MONETARY SYSTEMS

WE have already set out three formal definitions of money. Before considering the effect upon economic usages of coined money we can with value consider a fourth definition.

> " Money has been inaccurately spoken of as merely a means of circulation. It is, on the contrary, an expression of right. It is not wealth, but a documentary claim to wealth, being the sign of the relative quantities of it, or of the labour producing it, to which, at a given time, persons or societies are entitled. If all the money in the world, notes and gold, were destroyed in an instant, it would leave the world neither richer nor poorer than it was. But it would leave the individual inhabitants of it in different relations. Money is, therefore, correspondent in its nature to the title deed of an estate. Though the deed be burned, the estate still exists, but the right to it has become disputable.
>
> " The worth of money remains unchanged as long as the proportion of the quantity of existing money to the quantity of existing wealth or available labour which it professes to represent remains unchanged. If the wealth increases, but not the money, the worth of the money increases ; if the money increases, but not the wealth, the worth of the money diminishes. Money cannot, therefore, be arbitrarily multiplied any more than title deeds can."

That is John Ruskin speaking. As so often happens when he discusses political economy, his dogmatism leads him into minor inaccuracies. If, for example, all the money, both gold and notes, were destroyed, the world would be left poorer—but only by the loss of so much gold and so much printed paper. Also, money and title-deeds can both be arbitrarily increased, and we

have seen the process at work during the past two decades. What Ruskin means is that, if there is such an arbitrary increase, certain evils, which we shall later survey, must follow. But the main strand of his expounded definition is that money is an expression of right either to commodities or labour, either to goods or services.

When money consisted only of pieces of precious substances, whether marked for weight or fineness or unmarked, the right was inherent in the money, for the money was itself a commodity for which goods or services would be freely exchanged. When coins came into use the same inherent right characterized them. Coins could at will be melted down and their substance converted into ornament or placed to some utilitarian purpose. But the coming of coinage tended to separate the exchange use of the coined substance from its commodity use. Before the onward progress of coinage, unminted metal fell from economic grace as a medium of exchange.

Value or Authority?

Coins were first stamped with symbols of weight or fineness and next with symbols of religious or temporal authority. They bore the impress of an issuing authority. It was not long before the generality of men felt that the impress was of more importance than the substance impressed. Coins became known not by the terms of their weight or fineness or value, but by the names of their impress. The Florin (flower piece) and the Angel are examples of this tendency fully developed in the earlier days of our own history. In time it was not the intrinsic value of the coin which, in practice, was felt to guarantee the right to goods or labour which it expressed, but the authority under which it was issued. Coins

badly debased by usage were accepted as readily as new coins, on the strength of that authority. Since many persons could coin metal and stamp the coins with images, dishonestly, perhaps, putting into circulation as gold or silver some amalgam or spurious metal, the need for securing sound, if not single, authority behind coinage must have been early apparent, and was, indeed, early attempted.

The actual minting of coins was probably undertaken first in religious centres, but it was not long before the State insisted upon making a monopoly of coinage, and for obvious reasons, indicated above. History records that in the Persian Empire under Darius this monopoly was exercised, as in Rome under Augustus. Sometimes the right of minting subsidiary coins was delegated to underlings, and very frequently several authorities were minting coins for circulation in and over one area. But the hold of the State over coinage grew more firm. The consciousness of exercising such a hold affected the relationship of many rulers to money and to their subjects. Since the State could do what it wished with the coinage, there was no longer felt to be a need for each coin to contain the amount of exchangeable substance equal to its nominal value. Coinage was in some cases systematically debased. Solon in 594, debased the Athenian coins by one quarter in order to reduce all debts by that amount. In post-pagan Europe debasement frequently occurred, although the name and supposed value of a debased coin remained unchanged. Without realizing it, ordered societies came within reach of a concept of purely token money, in which the intrinsic value of the coin, like the intrinsic value of a note, bore no relation at all to the value of the goods or services which it represented.

An Analogy.

In order to make this process clear, let us take an analogy. Suppose ten men to be snowed up in a "Wild West" club house. One of the ten is the steward, who has control of all edibles. For some reason the steward will not accept any promises to pay over the names of the nine men, but he exchanges with them for their watches and cigarette cases various goods which they need. Eventually it occurs to him that it will be easier for all concerned if he uses as a means of exchange some one article which all regard as being of value. He selects buns, of which he has a considerable stock, and fixes the value of all his commodities in terms of buns, one bun being worth two cigarettes, five buns being worth a bottle of soda-water, ten buns being worth a plate of meat, and so on. After a while he runs short of buns, but remembers that there are some cardboard buns in a show-case. He issues these, and it is a matter of indifference to him which kind of bun is presented. He gave, shall we say, fifty buns to Deadshot Dan in exchange for a hunting knife. Deadshot Dan knows that at any time fifty buns will be taken in re-exchange. Big Bill had a hundred buns for his watch-chain. He spent forty of them on food and ten on drink, and lost three to one of his companions over a game of cards, winning five more later in the day. He thus finds himself with fifty-two buns. But two of them are cardboard. He takes them to the steward, who gives him either two genuine buns, which he wishes to eat, or four cigarettes, or some other commodity. Still wishing to increase the number of buns in circulation, the steward finds that he has neither genuine nor imitation ones to issue. He thereupon tears up some club note-paper and writes on each piece. "This is one bun" and the nine snowed-up

men accept them, knowing that they will be taken at their face value whenever a purchase is made, or whenever the settling-up day comes when the club-house is thawed out. When Deadshot Dan eventually buys back his knife he gives to the steward not fifty buns, but thirty buns, ten cardboard imitations, and ten pieces of paper.

A real, instead of an imagined, example of the same process can be seen in the history of any gaming house, where first the gamblers used real money for each stake, but where now they use ivory or celluloid chips stamped by the management with their token value.

Value and Content.

For some centuries there was wild fluctuation in the relationship between the nominal value and actual metallic content of coins, but there was not yet reached a state of confidence whereby the metallic content was of no account. When money was to be used outside the lands of the issuing authority there never could be a disregard of the metallic value, nor is there to this day. Different groups of coins were in use side by side, and the relative value of these groups was not itself fixed and constant. Bills of exchange actually laid down the type of coins in which debts were to be paid, and as late as the days of Frederick the Great, a general principle of law was enunciated that " every debtor must repay the debt in the same type of currency in which he received it."

The various types of coinage did not unify naturally into a system. Currency (circulating money) was, until such a system had been created and imposed, what we call **money of account.** In Florence in the late thirteenth century there were three different accounting systems. In Venice there was a gold currency and three different

kinds of silver currency based on the old soldi, the old soldi being itself in circulation with its small money. Legal attempts to establish and formulate reciprocal relations between these types were made without success. In Germany the types of coins in circulation were much more numerous.

To-day a debtor—assuming that he uses coin at all, which is unlikely—has no option but to repay his creditor in money of the same type as that which he borrowed, but such a unification of system was not easily reached. In Ruskin's metaphor, the title-deeds to the wealth and labour of the community were in the older times of many kinds and of varying authority, and though their validity was not in question they differed both in the degree of confidence which they commanded, and in their interchangeability.

§ 2

In due course the State was able, not only to monopolize the function of minting[1] coins, but also to protect the coins it minted from deliberate debasement and misuse by the community. Coins of the same denomination, containing the same value of metal, thus remained stable in their ratio one to another. But no State was able to keep stable the ratio of gold coins to silver coins, because gold and silver fluctuated in value as commodities. The State could arbitrarily fix a ratio of value

[1] Readers of a work such as this will be familiar with the word "mint," but, for the benefit of any to whom the word is new, the Mint is a place where money is coined. The name comes from the Latin *moneta* (the warning one), a surname of Juno, in whose temple at Rome money was coined. The Anglo-Saxon *mynet*—money—is, apparently, the link between the two. From its application to the coining of money the word has passed into wider usage, and is often applied to any source of abundant supply or any place of invention or fabrication. Bibliophiles are accustomed to speak of first editions as "in mint state."

between the two metals, saying that x pounds of gold would always be worth y pounds of silver, and could coin the metals accordingly, but the trading world would not thereby be deceived. If a bagful of silver coins by this fixed standard was worth x pounds of gold, but melted down became worth x plus $\frac{1}{2}$ pounds of gold in an open market, the silver coins would all be driven into the melting pot. Conversely, if a bagful of silver coins by the fixed ratio was worth x pounds of gold, but in the open market was worth only $\frac{1}{2}x$ pounds of gold, it meant that x pounds of gold at the Mint became worth silver coins to the value of only $\frac{1}{2}x$ pounds of gold in the market. Gold would not then go to the Mint.

But if the State could not arbitrarily fix with any success the ratio of gold to silver, it could—and did—detach one of the two metallic coins from any relationship between its nominal value and its metallic content.

Three Standards.

The history of coinage thus shows us three standards. There is the **parallel standard** in which gold and silver coins circulate in complete independence of each other, not being on values interchangeable. There is the **double standard**, in which both gold and silver are freely coined, in which their ratio is fixed, and in which both are full legal tender. There is the **single standard**, in which one metal alone is freely coined in coins of full intrinsic value, and made full legal tender; and the other metal is not given an exact coin-content in accordance with the nominal value of the coin.

Dr. William A. Shaw in his *History of Currency* examines in detail the lessons to be learnt from the history of bimetallism (i.e. the double standard), and it is sufficient here to state with unashamed dogmatism that under a

double standard if one metal depreciates it will drive from circulation the metal which is appreciating.

This is one phase of the working of what is known as "**Gresham's Law,**" which is that bad money tends to drive out good money. Sir Thomas Gresham, who was founder of the Royal Exchange, and whose life is an interesting study in Tudor morality no less than in Elizabethan finance, is credited with the discovery of this law without warrant, but, whoever discovered it, by his name it is known. It applies not only to metals under a double standard, but also to money under a single standard, which is susceptible to depreciation. Coin which bears a denomination over its actual and intrinsic value as metal, or paper money which cannot be redeemed in good coin, is "bad money" and its circulation drives away "good money," for the simple reason that none but the thoughtless or the foolish will willingly give a coin of honest gold for a coin of dubious gold or for a piece of paper which may at any time prove worthless. He will prefer to hoard or melt the good coin, and will pass on the bad money to his creditors. Even the State itself will be compelled to illustrate the workings of the law, for whereas the State can compel its own nationals to accept bad money it must pay to foreign creditors acceptable—i.e. good—money. Good money will thus be gathered together for export, leaving the bad money at home.

It is worth noting, in passing, that money may become bad money in three ways: (1) by a change in the ratio of its intrinsic value to the fixed ratio which it bears to some other metallic coinage; (2) by being "sweated" and "clipped" by its users; or (3) by being deliberately reduced in weight or metallic content by the State which issues it.

Free Coinage.

In setting out the three standards—parallel, double, and single—I have used the term "freely coined." By **free coinage** is meant a situation in which the Government, or its agent, will accept for coinage any of the approved metal which is offered to it. In this country, until 1925, the Mint was prepared to take whatever quantity of gold was brought to it. Since 1925, it accepts gold only from the Bank of England, but the Bank will buy gold to any amount from any customer, which, in practice, amounts to free coinage. The minting authority may, if it wishes, make a slight charge for its services—a charge known as **brassage** or **seigniorage**—or it may perform its minting function without charge, but the coinage is a free coinage in either case, so long as no proffered metal is refused. The object of free coinage is simply to ensure that the value of the gold as **bullion** (gold or silver regarded simply by weight as merchandise) is always in the same ratio to its value in terms of coinage. In the United Kingdom the Mint would always return $3\frac{143}{160}$ sovereigns for every ounce of gold. Thus this number of sovereigns was always equal to an ounce of gold, since either could at will be turned into the other. Without this free coinage the effects of Gresham's Law would be quickly felt. The tendency of bad money to drive out good obviously operates only when there is no scarcity, since scarcity will cause all money to be used, but since no Government permits scarcity, unless it desires to compel the acceptance of bad money, free coinage is at once a guarantee and a means of reassurance.

§ 3

This country is to-day on a gold standard. Before considering the operations of that standard we must

survey the history of our currency in order to appreciate the manner by which we came to its adoption, and why, after the interruption of the war years, we returned to it in 1925.

In the mid-years of the seventeenth century our English coinage was circulating in effect under a parallel standard. Gold and silver coins existed side by side without having any connection, fixed ratio, or reciprocal relationship. Traders, however, did not relish having to calculate in two systems of account, and towards the very end of that century a return was made to a double standard. The guinea was fixed at a ratio to the silver coinage of 1 : 15·93, which was ·93 higher than the actual ratio, bringing the coin to a value of 22s. In 1717 the legal tender value of the guinea was fixed at 21s., and in the following year resolutions were adopted which provided that no future alterations could be made in regard to the metallic content or normal value of either gold or silver coin. The guinea at 21s. was in ratio to silver as 1 : 15·21, or, in other words, an ounce of gold would be coined into the same amount of money as 15·21 oz. of silver.

But although the resolutions of 1718 prevented future changes in the scheduled rate, the market ratio was changing rapidly. In 1760 1 oz. of gold was worth in the market only 14·14 oz. of silver, although the Mint was still coining an ounce of gold into as much money as 15·21 oz. of silver. Silver was subject to the working of Gresham's Law, and began to go out of circulation. For 100 guineas a man could on coinage ratio get 2,100 shillings. But the silver in 2,100 shillings would buy in exchange enough gold to make 107½ guineas. The man who hoarded shillings instead of circulating them could, as silver was freely coined, thus make a profit of 7½ per

cent on every 100 guineas' worth of shillings he procured and saved.

England's Standard.

Then came a turn of the wheel. Gold production lagged and silver production increased. By 1800 the market ratio was 1 : 15·68. The opposite effect was felt. Silver began to drive gold out of circulation as coinage. This effect had been foreseen, and in 1798 the Government provisionally stopped the free coinage of silver. In 1816 the provisional stoppage was made absolute. England was on a mono-metallic basis. She had adopted the gold standard, which a century later was to embroil politicians, financiers, bankers, and industrialists in one of the bitterest controversies of our time.

Before examining the gold standard as it has operated in Great Britain, and having in view the fact that we shall later have to discuss the foreign exchanges, including the rupee exchange, I will quote here a passage on the double standard from Professor Clay's *Economics for the General Reader*.

Professor Clay writes—

> " Even when a Government tries to maintain the two metals in circulation together as standard money, it fails, because the relative value of the two metals is constantly fluctuating with the varying rates of their production ; the metal undervalued by the Mint tends to disappear from circulation, so that the country is really on a mono-metallic basis, the metal overvalued by the Mint being the actual standard of value. Only if the chief commercial countries of the world combined to maintain both metals in circulation could this result be prevented. The use of them as coin is much the most important use of the precious metals ; a ' combine ' of the Mints, therefore, could control the bullion market and fix the values of bullion, just as any strong combine can to some extent control values. Then a fixed ratio between the two metals could be maintained in the bullion market, and no divergence between

the Bullion Ratio and the universal Mint Ratio need occur. Such a treatment of the precious metals would constitute not a *double standard*, but a *joint standard*; its advantage over existing mono-metallic monetary systems would lie in the fact that the value of gold and silver together would probably fluctuate less than the value of either gold or silver separately. It would also get rid of the difficulty caused by the absence of a par of exchange[1] between gold-using and silver-using countries."

Since that passage was written, in 1916, international co-operation has gone far, but the use of gold as coinage has tended to decrease. It would almost seem that if the great commercial countries of the world could combine to regulate the bullion ratios of gold and silver, they could combine, through the League of Nations, to effect an international coinage on a credit basis, and thus leave the market free. It is a fine point whether regulation of the commodities, as such, would not be a worse artificiality than the present divergence between the bullion and coinage ratios. On the other hand, any concerted step to obviate the problems which arise in exchanges between gold and silver countries might be justified, whatever trading difficulties in gold and silver as bullion it created. We shall discuss in a later chapter the possibilities of international co-operative action with regard to currency, but in considering the gold standard Professor Clay's point should be borne in mind.

§ 4

In our imaginary example of the progress from barter to a double standard of money and on to a paper currency we saw our snowed-up men exchanging their personal possessions first for commodities, next for buns, to use as money, next for buns of either flour or cardboard and,

[1] This expression is explained later in the chapters dealing with foreign exchanges.

finally, for pieces of paper marked with the statement that each piece equalled one bun. In glancing at the history of currency we have seen coined money circulating in two forms, one where the coin had an intrinsic value equal to its nominal value, and one where the nominal value of the coin was greater than its intrinsic value. Metallic money of the second kind is, in effect, only a promise to pay stamped on metal.

For such money there are many substitutes. The ancients, we have seen, used tablets of clay or pieces of parchment. The moderns use paper. Paper money may be of two kinds, convertible and inconvertible. Paper money not convertible is merely a statement by the issuing authority that each piece is equal to a certain sum of money. When a pound note is issued which is not convertible the authority writes "This is one pound," just as our Wild West club steward wrote "This is one bun." Inconvertible paper money is known as **Fiat Money.** Even paper money which ostensibly promises to pay metal on demand is sometimes only fiat money, inasmuch as the promise is not intended to be redeemed.

A Paper Standard.

It must be understood that paper money does not by its mere use and existence constitute a paper standard. This country at the present time (1929) holds to the gold standard, but uses paper money, the redemption of which in metal is allowed for, but not contemplated. We speak of a paper standard only when the original metallic currency has returned to a commodity status the fluctuations of which are expressed in price terms of the currency actually circulating, that is in inconvertible paper. The British pound and ten shilling notes, whether issued, as now, by the Bank of England, or, as between

1925 and 1928, by the Treasury, could at any moment be exchanged for gold under certain conditions. The notes issued between 1914 and 1925 were in a different case, and did constitute a paper standard.

The first paper currency system was inaugurated in relatively modern times by John Law, a Scot, who flourished between 1671 and 1729, and whose finance was often only less fantastic than his personality. Those who care to read his biography by George Oudard, translated by G. C. E. Massé, will find therein an interesting account of the bank which he founded in Paris and from which the first large scale paper system emanated. The collapse of his system led to catastrophic depreciation and the eventual abolition for a time of paper money. The *assignats* of the French revolutionary period had a similar history. These started their lives as interest-bearing State bonds, but within a year had ceased to bear interest and were in use as a forced currency. In almost every instance a system of paper currency has been inaugurated in times of great economic stress by a State desiring to pay its debts. Ricardo shrewdly defines such currency as money bearing a seigniorage of 100 per cent, although the 100 per cent is not clear profit, since the money comes back in part as payments to the State by its own creditors.

A Simple Procedure.

The procedure is simple. The printing machine runs off the notes. The Government which owns the machine pays its debts with the pieces of printed paper and authorizes all users to pay their own debts with the same medium. But, as we have seen, money is from one point of view only the expression of a right to goods or services. If at any time there are issued

more expressions of right than goods and services can satisfy—if, that is, there are more title deeds than estate—the result is obvious. The title deeds lose their value. Could the issuing authority know at every stage the amount of goods and labour which would be available, and could it regulate its paper currency accordingly, the paper standard would not be open to the objection which both financial theory and financial history combine to level against it. These things are, unfortunately, unknown quantities. Even if the amount of paper originally issued be just equal to the need for currency, a trade fluctuation may render it excessive, and while it can easily be increased it cannot easily be restricted once it is in circulation. It must depreciate.

Some paper money, of which most of our own bank-notes and the American gold and silver certificates are examples, is in effect a receipt for, or a right to, bullion. Its use is as a convenience, since a piece of paper can more easily be handled than a large bulk of metal, either in the form of bullion or in the form of coin.

All paper money, however, whether issued by a central authority or a bank, and whether or not backed cent per cent by metal, consists of credit instruments, which, as such, will be discussed in a later chapter.

§ 5

Great Britain, as we have seen, came by almost forced stages to a mono-metallic standard in 1816. The metal selected was gold. Only during the war years, and then reluctantly and temporarily, was that standard abandoned.

What is **the Gold Standard?** It is a standard whereby the sovereign is fixed at the worth, nominal and intrinsic, of 123¼ gr. of standard gold, that is to say, the value of money is definitely related to a specific quantity of the

metal. Gold is given free coinage and full legal tender value, both of which are denied to the other coins circulating as a token coinage. (In practice since 1925 free coinage does not mean, as it once did, that the Mint will take in bullion and return coins to the fixed equivalent, but means that the Bank of England will take over gold and credit the bringer with a sum equal to the currency equivalent. The principle is not affected.) It will have been understood from what has been said of double standards that, if free coinage and legal tender rights were given to the token coinage metals, the State would be presenting to all and sundry the difference in value between the nominal and intrinsic value of the coins.[1]

I do not wish at any stage of this book to involve the reader in the controversies which technicians of currency have conducted around the merits and demerits of the gold standard, nor can I at this particular stage, when the foreign exchanges are presumed still to be a mystery awaiting elucidation, even indicate successfully upon what points those controversies have turned. But it *is* necessary to examine the practical implications of that standard.

Gold Fluctuations.

We have defined money hitherto in three ways, as a means of transferring values, as a medium of exchange which is also a standard of value, and as a documentary claim to wealth, being the sign of the relative quantities of it, or of the labour producing it, to which, at a given time, persons or societies are entitled. If gold be the

[1] The student must distinguish between the Gold Standard, proper, and the Gold Exchange Standard. Of the latter more will be said in due course. Here it is sufficient to note that a Gold Exchange Standard necessitates no gold in circulation but the power to sell foreign exchange at a fixed price, which implies a gold reserve or securities readily convertible to gold.

standard of value behind money, it follows that, in theory, money is a documentary claim to so much gold, or to the wealth and services for which that quantity of gold would exchange. But money is also the return given for wealth or services with which the holder has parted. Gold being a commodity, its own value *vis-à-vis* other commodities is subject to fluctuations. If more gold is produced, the metal cheapens. If less gold is produced, the metal rises in exchange value.

As an economic unit of society I agree to exchange my labour for the labour of others. Convenience of exchange alone, as we have seen, causes me to express the value of my labour in terms of money. Let us say that I agree to write a pamphlet on bimetallism in exchange for a ride in a taxicab, a seat at a theatre, and a meal at the Hotel Cecil. I express my share of the agreement by saying that I will write the pamphlet for two guineas. The other parties to the agreement—without realizing it, since in real life the exchange is exceedingly complicated and involves the interposition of an editor or publisher who actually buys my pamphlet—express their shares in the bargain by saying that they will provide respectively a meal of the kind I wish, with wines and a cigar, for 21s.; a taxi for my use from my suburb for 8s. 6d.; and a seat at the theatre for 12s. 6d. This bargain could be conducted by my publisher's gathering three promises of these things from the persons providing them. Whenever I called upon the redemption of those promises I would receive the things for which I had bargained. But my publisher does not go to that trouble. He gives me pieces of money to the nominal value of two guineas, on the assumption, which we both share, that I can in turn pass on the money to the other three people and receive the things for which I wish.

The Real Bargain.

My real bargain, as I have phrased it, has not been made with the publisher or with the garage proprietor or with the *maître d'hôtel* or with the theatre proprietor. It has been made with the community. I provide the pamphlet: the community provides in exchange the things I demand, the functionaries mentioned being only the agents of the community. As a token of my claim on the community I am given money based on a gold standard.

But between receiving my claims on the community and exercising them, it may so happen that the supply of gold has been suddenly increased. It is no longer worth so much in the market. In other words, people demand more gold in exchange for their goods or labour. Prices have risen. My meal costs not 21s. but 25s. The taxi fare is not 8s. 6d. but 9s. 6d. My service to the community valued in terms of meals and amusements is unchanged: it is altered only in terms of gold. Had I not delayed in presenting my claims, I should not have been affected by the increase in gold. Similarly, had the publisher delayed paying me, my two guineas would have fetched less goods and less services at the later date.

At the next transaction the reverse might have happened. Gold might have been suffering a scarcity. The two guineas might have commanded more services than I had really bargained for.

Again, as currency is issued only against gold—broadly speaking—the temporary paucity of gold might have caused a shortage of currency for the trading needs of the world. Currency *qua* currency might be in heavy demand, and appreciating. (We have seen one effect of this in examining Gresham's Law.) Had there been no gold

standard, new currency, based on the trading needs of the users and their ability to supply goods and services to give it its ultimate value, would have been issued. The bargains made by individuals with the community would thus have remained stable, and would not have been affected by the " accident " of more or less gold.

Gold Standard Defended.

These disadvantages the gold standard indubitably possesses. Because of them it is often roundly condemned. What is to be said in its defence ?

We will try, first, to formulate its negative defence. Money must be based upon some standard, otherwise it cannot fulfil its double function as a medium of exchange and a standard of values. It may be based upon an agreed commodity, or upon the credit of those issuing it, or upon the actual goods and services which it represents in exchange. The actual goods and services are not in practice computable, nor is money susceptible to a speedy enough regulation to ensure its correspondence to such things as they fluctuate in daily trade. (I ignore, for the time being, regulation of the value of money by regulation of prices, with the dogmatic excuse that however such a method may appear in theory, it is a method not possible of execution in practice.) The credit of the issuing authority may not itself be stable, and will certainly vary internally and externally to the domestic area of circulation. Externally it may not be acceptable at all. We come, therefore, to a reliance upon some commodity.

Let us expand the above paragraph by viewing the situation from the angle of an external creditor. To him we say, " We will pay you for your goods and services by giving you claims on our goods and services, which we

reckon over a given period to reach a value of such-and-such a figure." He will retort that a political upheaval, a sudden appearance of hook-worm, or some other evil, may reduce the estimated value of commodities and services upon which our money is based, and he prefers not to take the risk. Or we say, "We will give you the written guarantee of our Government that you shall have goods and services to the extent of your debt on demand." He may retort that he considers our Government unstable, our Chancellor of the Exchequer a rogue, and the State at large a mass of corruption and bankruptcy. But if we say, "We will give you a commodity which is itself as valuable as your debt, quite apart from its use by us as currency," he will make no demur. (Any reader who is actually studying these things for the first time will, I trust, realize that all these examples are absurd simplifications of what really happens, and that I omit at this stage complications which will emerge later in this book. The examples do not, however, depart from the principles of transactions actually conducted.) In our interchange with our creditor it is at this point left to us to decide which commodity we shall use, always bearing in mind the fact that it must possess certain characteristics, such as general acceptability, durability, ease of transport, and so on.

In our selection the experience of the race, as we have studied it, helps us. We have seen many commodities, including cattle and grain and tobacco and gin used, and we have seen the precious metals eliminating them in the favour of mankind. Of these metals gold has established its place as the most suited to our needs. The gold standard, in other words, is *not* foisted upon the community by self-interested producers of gold or by self-interested bankers. It is pressed upon the community

by the lessons of economic history and the experience of mankind over many centuries.

A Positive Claim.

If we must select a commodity basis, gold has not only a negative but also a positive claim to its place. It has all the qualities demanded of a commodity used as money, whether coined or uncoined, and, in addition, it is less liable to fluctuation than any of its rivals which may share most of those qualities. The ratio of addition to existing stocks is, even in a heavy production period, small (see page 31). It is true that Professor Gustav Cassel has predicted a probable scarcity of gold in the relatively near future, estimating that when in 1940 the world requires an annual addition of new gold to the value of £150,000,000 sterling there will not be available a moiety of that amount, but his prediction is neither supported by all his fellow authorities nor is the estimated requirement of an annual £150,000,000 of new gold necessarily sound in view of world changes. In any event, the gold standard is not a fetish which, like Rimmon, must be upheld at all costs despite all changes of circumstances. Should gold lose its negative and positive claims to its place as the standard, the commodity which usurps it must then replace it. But that time is not yet.

The gold standard has yet another justification. Not only is gold as a means of exchange generally acceptable, but gold as a currency standard is generally acceptable. This means that gold becomes, as it were, the common denominator of values between countries all of which are on the gold standard, and so ensures that commodity prices—exceptional local conditions excepted—will remain relatively stable on a common level. And, finally, the gold standard has the towering advantage over rival

standards, that it is in being and it works. Statesmen and financiers must of necessity be Pragmatists. "That which 'works' for me, is true for me," is a not unfair colloquial summing-up of the teaching of the Pragmatists in philosophy; and even if one were prepared to admit in theory all the arguments urged against the gold standard, that teaching would still apply. As Gilbert Chesterton says in *Orthodoxy* of the universe, we may say of the gold standard when its critics impress upon us the number of potentialities which it possesses for disaster, "Remember, however, that to be breakable is not the same as to be perishable. Strike a glass, and it will not endure an instant; simply do not strike it, and it will endure a thousand years."

In other words, much of the virtue of any standard rests in its acceptability, in the confidence which men have in it. Retain that confidence, and the standard will operate well and efficiently. Remove it, and the standard immediately displays its disadvantages in operation rather than its advantages. To those who do not appreciate this factor I can only say, "Behold! I show you a mystery"—but a mystery to which our national experience for over a hundred years has attested.

Normality the Test.

Having said so much, however, I must utter one word of caution and warning to those who propose to enter at any time upon discussions and arguments as to the value of the gold standard. The normal operations of such a standard are not to be judged by the effects which follow a return to it after a departure from it. The arguments for a return to a gold standard are not the same as the arguments for a continuance of such a standard already in use. Nor can any standard or monetary and currency

system be judged from experience gained in years when the whole economic relationships of mankind are disturbed as they were during the Great War. The test of a standard is its benefit in years when trade is normal and human interchanges and exchanges are being conducted without the hindrance of social disturbances.

CHAPTER IV

CURRENCY AND CREDIT

OFFICIAL money in circulation we have spoken of as currency. It may consist, as we have seen, of metallic coins or of pieces of paper representing, in theory if not in practice, either such coins or the equivalent value of the actual metal. Since money is only the token of a right to call upon the goods or services of others, whether it be a right backed by the intrinsic changeable value of the token or only by the authority of the State issuing the currency; and, since under a monometallic system those goods and services and the demands for them may at any time much exceed the metal available behind the tokens, it is obvious that the more complex grew society the more inadequate for its needs was the official currency. When we say loosely that a man is worth £20,000 we do not mean that he has £20,000. We mean that his possessions have an exchange value equal to that of such a sum. But a man worth £20,000 can always, we know from our everyday experience, call upon goods and services in excess of the value of his possessions. He is trusted to the extent of the margin between what he is actually "worth" and what we think he can make himself "worth." Also if such a man desired to exchange some of his goods for our services or our own goods, we should not insist that he immediately made over one of his houses, or gave us one of his motor-cars. We should give him credit.

Credit is not easy shortly to define. It is a word actually derived from the same root as our English creed, which

comes from the Latin *creditus—credo.* Credit means belief. If we give a man credit, we give him our trust. We believe in him. The extent of our trust in him may be regulated by the palpable security which he offers. Thus, if a man has goods to the value of £10,000, we might trust him to that extent but no further. But our trust in him might be regulated by quite other considerations. He might be a man of small possessions but of excellent character. Having nothing he might solicit our trust, and we would give it not on palpable security but on impalpable security—the security of his character and prestige. Mr. A. may have goods but no money. Mr. B. may have neither goods nor money, but the expectation of both. If we render to either our goods or our services, being content to await the just return, we have given credit.

Credit Essential.

In actual working life, however primitive or however complex, the giving of credit is a prime essential to any relationship. If I take a job of work under an employer one of two things must happen—either I must give him credit for my pay, which will come to me only after some work is done, or he must give me credit for my work, which I will perform after payment. Otherwise the work would be constantly interrupted while I stopped to take payment for each minute portion or moment of it. In larger transactions the same inevitability of credit is found. Unless goods are handed over only at the very moment that the money for them changes hands, either the buyer gives credit to the vendor for the goods or the vendor gives credit to the buyer for the money, or whatever is being taken in exchange.

In a very simple society, where every person was

well known to every other person and where a high standard of commercial morality obtained, no acknowledgment of credit might be necessary or demanded. But in more complex societies, where the parties to a transaction are unknown to each other or known only by repute, and where the giving and taking of credit is frequent, so that one man may be indebted at one and the same time to dozens or hundreds of his fellows, some record of these credits is necessary. The record is necessary from two points of view. A man without some record of the transaction might deny having been given credit. A man without some record of many transactions might fail to recall some credit which he had given.

A formal acknowledgment of goods or services received but not yet paid for is an acknowledgment of debt. If I happen to hold several such acknowledgments, and there is every human certainty that the debts in due course will be paid, it follows that my own credit does not suffer by the fact that I have parted with my goods. Should I wish to obtain goods from some other person, I could use those acknowledgments as proof that I would at some future time be able to pay for whatever I wanted.

Transferred Acknowledgments.

One of two things would then happen. Either the person from whom I wished to obtain the goods would give me credit for them—that is, he would believe first that the people owing me money would pay me, and. secondly, that having been paid, I would in my turn pay him. Or he would consent to my transferring one of the acknowledgments to him. Let us suppose that I go to John Doe and say, "Look here, my dear fellow, I want to buy from you that etching of which you spoke

last night. Can I have it now, and pay you when your brother Richard pays me for the work I did for him last week ? Here is Richard's letter promising to send me my money next Friday." John Doe might say, " Certainly—but you might give me a line confirming the arrangement," or he might say, " Righto ! I want £3 for the etching, and I see Dick is to pay you just that sum. Give me his letter and I'll collect it from him myself, and we'll call it square all round."

Or the transaction might be a little more complicated. John Doe's etching might be a Whistler for which he wanted not £3 but £30, and I might have to tell him that I could pay for it only when his brother Richard had paid me for my work, when Motherans had paid me for some rare books that I had just sent to them, and my publishers had sent me the money owing for my royalties to that date. Even so, his reply would still, perhaps, be one of the two which I have suggested, although he might add that since it would be some trouble for him to collect all three of my debts, in the second event, I ought to give him a few coppers over the £30 to pay for the use of a clerk or somebody to make the three calls.

After I had departed, hugging the etching under my arm, John Doe might meet someone from whom he wished to make a purchase. Having no money in his pocket he might persuade this person to accept one of the acknowledgments of a debt to me, both knowing that my debtor would not fail to meet his obligation. The person to whom he passed the acknowledgment might happen to be another of the people who owed me money, and might very well call upon me and pay me by passing back to me again the acknowledgment of Richard Doe's debt which he took in payment from John.

Augmenting Currency.

What would have happened in these transactions would have been that John Doe and his friend and I had been using the acknowledgments of the debts to me as money. In our own circle we would have augmented the official currency, of which we were all short, by an unofficial currency of our own, consisting of acknowledgments of debts backed not by any metal but by the credit of those making them, who may pay in goods or services.

That imaginary series of trading encounters is an epitome of what has always happened in trading communities. In addition to money, men have always used tokens of credit as means of effecting exchanges. Whether by a clay tablet, a piece of parchment, a cheque, or a bill of exchange, **instruments of credit**, have always augmented the official currency.

§ 2

The first effect of the use of credit instruments as money is that they economize the use of gold. If for the etching I paid John Doe in gold while my various debtors were sending gold to me, or if none of us at any time would accept anything but gold, we should need a large supply of the metal. The effect would be the same if we used notes for which gold was waiting at any time we wished to demand it in exchange. But by using credit instruments we can actually trade without using any gold at all, for John's friend, instead of bringing back to me the credit instrument issued to me first by some other debtor, might have brought back to me in payment of his debt an acknowledgment from me to someone else of a debt of that amount. If that had happened I would simply have torn up the acknowledgment and the two

debts would automatically have cancelled each other out.

A credit instrument used as money *is* money, for it is the expression of a right to goods or services. If I have the right to the goods and services of others and others have the right to certain goods and services of mine it may be as convenient for us to wipe out any mutual rights as to exercise them. In this process of cancellation not even credit instruments may be used. If, for example, I sell all that I write to a certain literary agent and he, through some subsidiary business, supplies me with all my stationery and typewriter ribbons, and we both have perfect trust in each other, he may simply enter in his books the value of any writings I send him and the value of any stationery he supplies to me. At the end of an agreed period he will subtract one from the other and for the balance will give to me either official money or a credit instrument, which I can either exchange for money, use as money, or exchange for goods and services.

But in practical life we rarely meet with such simple transactions. It is more likely that I pass my literary wares to my agent, who sells them to a publisher, and I buy my stationery from a local shop, which is, let us say, on a site owned by the publisher. Let us suppose that the publisher owes me a small sum, say £12, which he passes to my agent not by cash (the name we give to officially coined money) but by some kind of credit instrument. My agent deducts an agreed commission of £2 and by another credit instrument pays me £10. I owe £3 for stationery and pay that also by some kind of credit instrument, the stationer passing it to the publisher as his week's rent. In this case the conflicting "rights" have never exactly met. Had the publisher passed direct to me his credit instrument for £3, and had I passed

that direct to the stationer, who passed it back to the publisher, there would have been a simple cancellation.

Overlapping Claims.

But, although in our joint transactions we have not managed to bring together our mutual "rights" over goods and services, there must be in the community many other people in some kind of trading relationship with the agent, the publisher, the stationer, and me. Most, if not all, of our calls upon the community could be confronted by the community's calls on us. As we have earlier seen, the use of money is to make easy for us the exercise of such rights and calls, but money may be scarce, or for various reasons it may not be available to us just how and when we need it. It would be to our advantage, therefore, to find somebody who would establish some small new claim on each of us by and for his services in discovering just where our various calls on each other overlap, and so help us to cancel instead of fulfilling them.

Hitherto we have assumed that all acknowledgments of debt are of such a nature that the persons concerned would have no worry that they might be repudiated, or the debts not discharged. If, however, they pass from one hand to another it may easily happen that someone will not trust them. It may also happen that one or two of them are not trustworthy. A man may have acknowledged his debt to me, and may even have promised to pay me the return I demand at a given time and place, but I may feel that I would be happier with something more tangible than his promise to pay. I might be willing, that is, to take a little less from the community than he is to render to me for the satisfaction of knowing that I have at least secured something.

Feeling thus about one of the acknowledgments of debt that I hold, say that from Richard Doe, I might go to John Doe and confer with him as to his brother's capacity to pay. John might feel about his brother much as I felt, and yet be of greater trading courage.

Payment for Risk.

Richard, owing me £3, has given to me some kind of credit for that amount. John says that if I like to transfer my risk of non-payment to him he will give me £2 10s. for his brother's acknowledgment of debt. In other words, for a fee of 10s. he will risk £2 10s. of his own money. We might almost phrase it another way and say that he wagers £2 10s. (the amount he will lose if Richard defaults) against 10s. (the amount he gains if Richard pays) that his brother will meet his debt. He bets five to one that his brother is a sound man. If I ask him if he will also take over two other of the credit instruments I possess, one from Lord Tomnoddy and one from Parson Jones, he will not, as it were, lay the same odds. He knows Lord Tomnoddy for a rake and a spendthrift, whose estate may already have been half dissipated. He knows Parson Jones as the soul of honour, about to receive tithe. For the instrument of credit from Parson Jones acknowledging a debt of £3 John Doe will give me £2 19s. 6d. For a similar instrument from Lord Tomnoddy he will only give me 30s. In the one case he has shortened and in the other case lengthened the odds which he wagers in favour of the man being sound. If, as we shall see later, he is a professional buyer of such instruments of credit he will call the acknowledgment from Parson Jones "good paper" and that from Tomnoddy "bad paper"—for obvious reasons.

The second effect of the use of credit instruments as

money is, as we have just seen, to create a new trade—that of handling such documents in order either to achieve an easy cancellation of claims and rights, or to take for a consideration the risk of any of them being unredeemed when the time comes for payment.

§ 3

Before turning from simple examples of how credit instruments are created and used, to an examination of the very complicated credit systems to which their use has given rise, and before naming the various kinds of such instruments and the functions of those who make it their business to handle them, it is necessary that we should study a little more deeply than we have yet done the use of money and the use of credit.

Money is an immediate claim upon the goods or services of the community. A credit instrument is generally a claim upon the goods or services of a particular member of the community which may or may not be immediate.

By the possession of a £1 note or a golden sovereign I have a claim upon the services of some jobbing gardener who happens to need £1. If I put my £1 in an old stocking, and do not exercise the claim, my wife goes short of the flowers with which she likes to bedeck her tables. The fault is mine. If I have in my possession an acknowledgment from Richard Doe that for services rendered he owes me £1, which he will pay next week, and no jobbing gardener will work for me to-day and take his pay a week after, my wife must either do without her flowers or I must find some means of turning Richard's acknowledgment into cash. I can only do that by selling it to his brother John, who will give me only 18s. for it. If John is not available when I want him, and nobody

else will buy the wretched thing, I am helpless. But even when I have sold it to John I do not get the full use of my gardener. I wanted £1 worth of work from him and get only 18s. worth. Also, I have lost time by having to find John and make the sale. John, in offering me only 18s., explains that he has no lack of confidence in Richard, but that he was going to use £1 of his money in employing a carpenter to make some gadget which would have been sold at a profit when made. By giving me the use of his money he is actually sacrificing that profit, which he estimated at 1s. 6d. He takes the slight risk on his brother's soundness for 6d. and recoups himself for his lost profit with 1s. 6d.

A Loan for Profit.

Having had my talk with John a bright idea occurs to me. The next time I find myself with a spare pound I will take it to him and suggest that he employ the carpenter again with my money and we share the profit which is made by the sale of the gadget. John reckons out how much of the 1s. 6d. profit should go to him for his own idea in making the article, for providing the carpenter with a place in which to work, and for the provision of the wood, and how much should come to me for the use of my pound. Since the calculation is made by him and not by me, he eventually says he will give me 3d. of the profit and keep for himself 1s. 3d. On those terms I agree to lend him my pound.

Had Richard's promise to pay been a promise to pay, not a week, but a month, later than the day I wanted my gardener, it will be seen that John could not with advantage to himself have bought it from me for more than 13s. 6d. The risk might have remained the same, at 6d., but in a month his pound would have enabled

him and his hired carpenter to make four gadgets, each showing a profit of 1s. 6d.

In my transactions with the two Does I have, however, learnt more than the fact that by laying out my pound I can make it fruitful. I have also learnt that the next time I do work for Richard, for which I have previously charged him £1, and he makes me wait a week for my money, I must charge him £1 0s. 3d., or be out of pocket. (Let me, in parenthesis, warn any budding financiers that a return of 3d. per week on £1 is not the return for which they may look with any confidence in real life. It serves, however, for our example.)

Refreshing Elementary Economics.

My readers will not thank me for a very elementary lesson in economics, which is really what I have just given to them, but if we pause now to identify and name the various acts and functions performed in my imagined intercourse with John Doe, we shall not be wasting our time. The task of understanding later the more intricate actual credit system will be greatly eased by our having refreshed our schoolboy knowledge in this way.

When John and I provided the carpenter (Labour) with a place in which to work, with tools and wood we were acting as **Capitalists.** The things with which we provided him were **Capital.** From my point of view the £1 which I lent to John that he might procure some of those things was also capital. The difference between the cost of producing the gadget—including wood, tools, rent, and payment to the carpenter—and the price which John got for it was **Profit.** The share of that profit which he returned to me for the use of my pound was **Interest.** The £1 itself in relation to that interest was my **Principal.** The money the carpenter had was his

Wage. When John took from me Richard's promise to pay he acted as a "**Bill Discounter and Broker.**" The difference between the amount Richard had promised to pay and the amount John gave to me for that promise, was the **Discount** at which John bought Richard's paper. Richard owing money to me was my **Debtor.** I, being owed money by him, was Richard's **Creditor.** The paper which Richard gave to me might have been a **Promissory Note,** a **Bill of Exchange,** or a **post-dated Cheque.** (These terms will be defined and discussed later in the book.) Had John at any time kept for Richard and me our spare money and the various credit instruments we possessed, either for collection on our behalf or until we asked him for them or asked him to pass them to someone else, he would have been acting as our **Banker,** and the place where he stored or from which he handled the money and credit instruments would have been a **Bank.**

Another Credit Transaction.

In my transactions with John and Richard Doe and the others of our circle there was, it will be seen, an opportunity for me to indulge myself in another transaction. Since John would give me 3d. for the use of my pound for a week, I might have looked about and found somebody who, out of friendship, would have lent me £1. That £1 I would have passed to John, receiving it again at the end of the week with an extra 3d. I could then have returned the £1 to the lender and kept the 3d. for myself. Or I could have persuaded somebody to give me the use of £1 for a payment of 1d., in which case I would have made 2d. Or I could have given a credit instrument to John, promising at the end of a week to pay him £1 0s. 1d., which he could have sold to somebody

for an immediate payment of £1, which would also have left me 2d. in profit, since at the end of the week John would have returned to me £1 0s. 3d., the person to whom he had sold my credit instrument would have called on me for £1 0s. 1d., the amount I had promised to pay, which call I would then have been able to meet. In this last example John and I together would have used my credit to procure capital from a third party. In all our transactions it might so happen that the only person demanding and receiving actual currency would be the carpenter, or it might happen that not even he received currency. The more persons engaged in a mass of transactions and the more organized and systematized the means of manipulating credit, the less the need for currency. In modern business, as we shall see, the use of coin has been reduced to a minimum.

§ 4

It must not be thought that, because credit, however organized, rests in the last resort upon the will and power of individuals to meet their obligations, its instrument is always less reliable than official currency. Currency itself, as its history has shown, is subject to fluctuations in value. We have temporarily accepted a definition of money which calls it a means of exchange and a standard of value. So it is, but its standard is never absolute. It might even be better to think of it for a moment less as a standard than as a measure.

Why Currency Fluctuates in Value.

In the last chapter I imagined a situation in which I had bargained with the community to receive certain returns in exchange for a piece of work, only to find that when I presented my claims the returns made to me

were less in value than I had anticipated. That change had been caused by a difference in the stock of gold behind the currency in which the exchanges had been made. But variations in gold, it was emphasized, were both small in quantity, relatively speaking, and inconsiderable in effect. The effective difference in the value of the return for which I covenanted with society, and the return which society actually rendered to me, might have been much greater had the currency employed not been tied to a gold standard.

To make this as clear as may be, for in the complicated economic life of a congested community the process is never really clear, even to the close and skilled observer, let me have resort again to an imagined situation where everything can be reduced to comparative simplicity.

An Analogy from the Schoolroom.

Let us imagine that the members of a group of five schoolboys have between them 100 ordinary marbles and 100 blood-alleys. (If any reader is unacquainted with the object known as a blood-alley, I fear I cannot define it beyond saying that it is a superior kind of marble which, like Elizabeth Barrett Browning's pomegranate, "if cut deep down the middle, shows a heart within blood-tinctured of a veined humanity.") These 200 marbles were supplied originally by the school tuck shop at 1d. for ten ordinary marbles and 1d. for five blood-alleys. Although in origin one variety cost twice as much as the other, they tend, by reason of both being equally common, to become equally valuable, so that at one period of the history of the group one blood-alley would only "swop" for one ordinary marble. But Jones Major, just before leaving this Dame's school for a preparatory school, celebrates a mood of high spirits by

firing away half the communal total of blood-alleys with his catapult. The ultimate effect of his act is to change the relative values of the marbles. One blood-alley will swop for two ordinary marbles. Owing to a seizure by a master, the public stock of blood-alleys becomes reduced to five. They have reached something of a scarcity value. Each member of the group desires to possess them. Let us also suppose that with their reduction in quantity there grows a convention that they are no longer to be used in games, lest some accident befalls them, and despite this convention they retain their attraction. It is at this point in the history of the group that we begin to examine the economic interactions.

The tuck shop from which came the marbles may be regarded as the **Bank of Issue.** The manufacturer from which the shop bought them we call the **Mint.** The blood-alleys, which will always swop for any other object which the schoolboy's heart covets, have become currency in terms of precious substance coined into a particular, recognizable, and handy shape. The tuck shop will never buy back the marbles, but there is a firmly held schoolboy belief that it will do so. We thus have an issue of currency believed to be convertible, but not in actuality convertible. The blood-alleys are virtually on a penny standard, for against them there was deposited in the shop's till twenty pence.

In the pre-historic times of Jones Major the value of a blood-alley was one-fifth of a penny. When we first observe the transactions of the group the value of a blood-alley has risen to 4d. The trading value, which was once equal to one ordinary marble, has risen to twenty marbles. We have, thus, an example of the difficulty observed when we looked at bimetallism of keeping the mint ratio to the market ratio of value.

Our five schoolboys know that twenty pence were paid for the blood-alleys, and they firmly believe that they have only to go to the tuck shop and for the five blood-alleys they will get that amount of money. They also know the relative scarcity of these desired objects. But, in a mood of altruism, the shopkeeper tells the school matron to slip into the play box of each boy a new blood-alley. In the transactions which follow, the blood-alley for a while retains its value. It will still swop for twenty marbles, or two old issues of *Sexton Blake,* or one apple, or one broken penknife, and so on. It is also thought to be worth 4d.

But gradually the group realizes, some of its members sooner and some later, that blood-alleys are not so rare as they used to be. There is no longer any special pride in possessing two of them. At one time to possess two enabled the owner to crow mightily over some unfortunate who possessed none, but now it is possible for each to have two. The trading and social value of blood-alleys drops, perhaps to ten marbles, perhaps not quite so far.

It also occurs to the financial genius of the group that as there now appear to be twice as many blood-alleys in circulation and as no more pennies have been deposited in the shop's till, if there is ever an attempt to sell them back to the shopkeeper each will only be worth 2d. Realizing this, the young financial genius acts accordingly and dispossesses himself of as many as possible while his friends still think them worth 4d., which again drives down their trading value.

What, during this process, is the position of Smith Minor? Smith Minor wanted to trade an apple for two issues of *Sexton Blake.* But Brown, who had the two issues of *Sexton Blake,* was in no immediate need of an

apple, and said he would only swop the two issues for a blood-alley. Smith having no blood-alley to give to Brown, swops his apple with young Gideon, our rising financier, for a blood-alley. He then seeks out Brown. But the value of the blood-alley has gone down. Brown now declares that he cannot possibly give both issues of *Sexton Blake* for one blood-ally because what he really wants is to acquire a broken knife which Thompson says he will swop either for two issues of *Sexton Blake* or two blood-alleys, blood-alleys having become, mysteriously, rather a drug on the market. Smith is therefore compelled to be content with one issue, while Brown swops the second one with Robinson for another blood-alley, and is thus enabled to purchase Thompson's broken knife.

Now, to the thoughtful Gideon, the strange thing is that the relative value of the knife, the issues of *Sexton Blake*, and the apple have not changed. Each will command the other in barter. It is only when the currency of the group is used that there seems to have been some alteration in values. Smith Minor, for his part, only knows that when he gave his apple for a blood-alley it was with the conviction that for that blood-alley he could buy both issues of *Sexton Blake*, whereas he was only able to buy one. In future he will have nothing to do, if he can help it, with the rotten blood-alleys. His confidence, as an economic unit of the community, has been badly shaken. In future he trades warily. In consequence the life of the group is neither so animated nor so thoroughly happy as it was before the shopkeeper *inflated the currency*.

In what did that inflation consist? What had the shopkeeper actually done? He had *increased the number of currency units, that is the means of exchange, without*

there being either a corresponding increase in the commodities and services to be exchanged or a corresponding increase in the wealth stored against the day when the currency would be presented for redemption. And the symptom of inflation was, as it always is, a rise in prices. (Thompson's knife cost Brown two currency units instead of one.)

What would have happened if, instead of currency being used, credit had been employed in these transactions? If Smith had said to Brown "Give me your two *Sexton Blakes* and I'll arrange to get Thompson's knife for you," he could then, in the interval, have arranged a deal in which Thompson gave his knife for the apple. Credit would have been sounder as a means of exchange than currency, providing the credit itself was not arranged in terms of currency.

Let us now follow the history of our five small boys a little further. Let us suppose that by some means, say the immoral rapacity of the butcher's boy, five of the ten blood-alleys are quietly withdrawn from circulation. The reverse effects from those we have just examined follow the withdrawal. The means of exchange have been reduced with no corresponding reduction in the commodities and services to be exchanged, and no corresponding diminution of the wealth supposed to be held against redemption. The official value, in pence, of the blood-alley rises from 2d. to 4d., and the social and trading values also rise. Brown, the day before this effect makes itself felt, swops a blood-alley for an issue of *The Deadwood Dick Library of Adventure*—that inspiring and elevating collection of moral stories for the young, issued in fortnightly parts from the Press owned by Lord Shovel, who is always telling the youth of the nation to read Milton and Shakespeare—as Robinson, having sated himself with the adventures of the hero, desires

to possess himself of something owned by another of the group. The value of the currency changes, and when, two days later, Brown trades the paper to Smith, blood-alleys have, owing to the reduction in their number, become much more desirable than when Brown gave his to Robinson. Before Smith will part with the blood-alley (which happens to be the same as that which Brown gave to Robinson) he demands not only the issue of *The Deadwood Dick Library of Adventure* but another and similar periodical also. In other words the price of such periodicals in that community has fallen. The currency has been *deflated.* Smith, who was fortunate enough to be holding currency, is enriched. Brown, who was unfortunate enough to be holding commodities, has been impoverished.

Again, credit—with the same proviso—would have been sounder than currency, for if Robinson had handed over his paper on Brown's promise to pay him at some future date with an issue of that soothing weekly serial story *The Crimes of the Human Bat*—issued from the publishing house of Lord Rabbitwarren, who began life as an evangelist in New Zealand and is still in demand at public functions on account of his power, by his silvern tongue, to convince his auditors that the best reading for boys is to be found in the English classics—neither would in their dealing have been quite accidentally advantaged or disadvantaged.

§ 5

The trading experience of our five schoolboys during periods of currency inflation and deflation is easier to expound and to follow than the experience of the great world in which their fathers traded during similar periods of currency inflation and deflation. But the experience

of the great world is the same thing writ large and with some added complications.

Although I have thought fit to introduce inflation and deflation here, in this chapter, in relation to credit, I propose for a moment to anticipate the chapters on international trade in order to mark immediately one effect of either process upon the national community which suffers it. A very detached spectator might ask why the individual losses of Brown and Smith should worry us overmuch, since the actual wealth of the community is unaffected. We have already noticed that under inflation the destruction of confidence does actually alter the wealth of the community, since it hampers and even destroys trade, and most certainly detracts from the happiness and *moral* of the citizens. But there is another and worse effect.

A Double Transaction.

When a foreign merchant buys goods from a neighbouring country he actually, however indirectly, performs two transactions. He buys the goods and he buys the currency of the neighbouring country in which he will pay for them. Let us suppose that Sam Slick, that flourishing American multiple-store owner, desires to buy from Europe certain fabrics. He may buy them from France or from England. They are worth to him exactly the value of some other fabrics which he is about to sell through his stores. That value let us put at x dol. On normal values a sum of x dol. is equal to a sum of, shall we say, for ease of argument, $\frac{1}{5}\,x$ £ or $4\,x$ fr. The fabrics he is about to sell are y yd. of silk. The fabrics he wishes to buy are z yd. of silk. In theory, other things remaining equal, he should be able to go to London or Paris and exchange his y yd. of one silk for z yd. of the

other silk, or for $\frac{1}{5} x$ £, or for $4x$ fr. Equally, he should be able to go to Paris or London and exchange x dol. for y yd. of one silk, or z yd. of the other silk, or $\frac{1}{5} x$ £ or $4x$ fr. His normal procedure is, therefore, when simplified down to its essentials, and not accounting for charges made to him by intermediaries, to exchange—if he buy in France—x dol. for $4x$ fr., and with the $4x$ fr. to buy z yd. of silk, his x dol. coming to him from the sale of the y yd. of silk. If he buy in London, he does the same thing with $\frac{1}{5} x$ £. Now, quality being equal, it makes no difference to him in which country he buys.

But France has inflated her currency and Great Britain has deflated hers. Francs have thereby become cheaper—which, as we have seen with our schoolboys, means that prices have risen to the Frenchmen. Pounds have become dearer—which means that prices have fallen to Englishmen. In one country z yd. of silk cost more francs. In the other country z yd. of silk cost fewer pounds. But Sam Slick is not concerned only with the internal price of silk. Another change has taken place. For his x dol. he can get more francs and fewer pounds, since francs are cheaper and pounds are dearer. As, in practice, the rise in the price of commodities is never exactly that of the fall in the currency-unit which has been inflated, it pays Mr. Slick to exchange his x dol. for a larger number of francs and to buy his silk in France. (This will emerge in greater detail later in this book.)

Inflation and Trade.

To revert for a moment to our schoolboys. When more blood-alleys were put into circulation, it took some time for the necessary readjustment of values to take place. When more francs were put into circulation—with no corresponding increase of things to be exchanged or

wealth to be given on demand—the same readjustment would have to take place, and would, in the affairs of a complex nation of many millions of currency users, take some time. By inflating her currency France has actually attracted trade. Manufacturers, or rather those of them who take a short view, and their workers who, from the circumstances of their economic life, can take no other, are very often made into advocates of inflation because of such an effect, and are nearly always bitterly opposed to deflation, which rebuffs trade by an inversion of the process.

But let us look at another transaction. Not only does Sam Slick want to make purchases in Europe, but M. Emile Renoir of Paris, and Mr. John Jackson of London, wish to make purchases in America. Just as Slick's dollars buy more inflated than normal francs, so M. Renoir's inflated francs buy fewer dollars. Just as Slick's dollars buy fewer deflated than normal pounds, so Jackson's deflated pounds buy more dollars. It is obvious which of the two Europeans is in the better case when he trades in the country of Sam Slick.

Again, M. Renoir and Mr. Jackson both have money invested in America. Each is to receive a return on his investments of x dol. With that return each proposes to buy z yd. of silk in his own country. M. Renoir for his x dol. gets more inflated francs than he would have got normal francs. Mr. Jackson gets fewer pounds. But M. Renoir knows that the price of French silk is rising, and that the price of the same silk in America is steady. It will pay him to spend his dollars in the country of their origin. By the time he has had his dollars converted to francs the process by which prices are overtaking the inflation of the franc may have lessened their value and have increased the value of the fabric. But the

longer the delay with Jackson before he converts his dollars the more he will get for his money.

Already we begin to see the disturbances and paradoxes which arise from either an inflationary or a deflationary process. (One such paradox, which we cannot pause to examine now, is that while it apparently pays Mr. Slick to spend his x dol. in France, it pays M. Renoir to spend *his* x dol., obtained from his foreign investment, out of France.) It must also be borne in mind that once currency is detached from a correspondence with some ascertainable standard of value—whether gold or some other commodity—its inflation or deflation gets beyond the control of those who inaugurate either process. To increase the number of currency units to double their original number, without a corresponding doubling of things to be exchanged or wealth to be demanded, does not give an exact equivalent in effect. The pound in such a case would not automatically drop in purchasing power to the former value of 10s. It might drop lower. It might not drop so low. Much depends upon incalculable factors, such as the social, as opposed to the trading, value of money. Much depends upon the realization of the process in the minds of currency users. Much depends upon the kind and quantity of exchanges which are being conducted.

Destroying Confidence.

It may, finally, be broadly said that inflation destroys confidence not only in the actual currency, but also in the authority issuing it and in trade itself, whereas deflation increases confidence. Whatever the immediate apparent gain of inflation, its cumulative effect is evil. Whatever the immediate apparent disadvantages to traders of deflation, its cumulative effect is good. But

the ideal is always, and must always remain, stability. In the last resort the argument for any adopted standard is that it gives to currency a greater measure of stability than any alternative commodity, and this holds good whether the standard be a metal, like gold, an estimate of production and services, or an estimate of exchange needs, upon which would be based any system of "managed currency," i.e. a currency increased or decreased in quantity in accordance with the supposed units of commodities or services available at any given time for exchange.

NOTE TO CHAPTER IV

[The purpose and scope of this book does not justify me in elaborating the mention made in this chapter of "the social value of money." As Mr. Belloc has insisted, it is essential to a thorough understanding of both economics and history that this aspect of money should be realized and taken into account. I can only refer my own readers to Mr. Belloc's *Economics for Helen*, where the subject is discussed briefly but adequately, and to his *History of England*, where it is examined more fully.]

CHAPTER V

BANKS AND THEIR ORIGIN

WE have seen how, in the smallest community, exchanges facilitated by money and credit instruments lead to a series of complex and constantly changing relationships whereby each man is at once a debtor and a creditor. The more numerous the persons engaged in exchanging their goods and their services, the more complex and entangled grow these relationships, and the more strong grows the tendency for each man to become a specialist in some form of production, distribution, or the business of exchange.

Ruskin postulated, as was the manner of the economists of his day, a desert island on which three men lived in amity. Two of them in different parts of the island produced necessary commodities, and the third acted as a carrier, taking from each of the other two a share of their produce. When it occurred to the carrier to withhold from each of his companions the necessary commodities which were in exchange until extreme need led the anxious producer to offer more in exchange than would otherwise have been given, the carrier grew rich at the expense of the men he served. That trio of men represented the primary means of human livelihood, production, and distribution. But as the desert island became more densely populated, from other vessels being wrecked there, and families being founded, the use of the third man would extend. He would not be merely a carrier of commodities, but would—or at least might—become a collector of credit instruments for exchange.

Eventually a new specialist would arise whose business would be the arranging of deals between men who had a store of the island currency and men who had credit which they wished to mobolize. The larger grew the community the more remote the chance of any two men being in close touch with each other at the moment when the needs of one to acquire goods or services coincided exactly with the needs of the other to give these things. Still more remote would become the chance of a man of good credit, who wished to borrow goods or money, of being personally known to a man with goods or money to lend.

The History of Banks.

Ruskin's three men on their desert island cannot be exactly paralleled in the history of any known community of to-day. We do not know with exactitude what were the trading relationships and methods of Adam, Cain and Abel before the murder, nor between the two settlements of the family after Cain had moved himself to the land of Nod and there acquired his mysterious wife. But we do know that the history of our own people, either in the British Islands or in other parts of the world, followed very closely along the lines of surmise which Ruskin, in company with the more formal economists of his day, laid down. A short survey of the history of banks and banking will reveal exactly how the business of mobilizing credit and facilitating exchange by the employment of specialists grew to its present importance.

Despite a notable outburst by Walter Bagehot, which those interested will find in Chapter II of *Lombard Street*, we must still trust ourselves very largely to " conjectural history " as to the origin of banking. We have definite knowledge that there existed, a thousand years before

Christ, Babylonians who were bankers and who lent out metal and goods, but we can only conjecture as to how far a habit of lodging precious possessions with a second party, who made temporary use of them to back his own credit, grew concurrently with "loan banking." When Bagehot rightly says that "the first banks were not founded for our system of deposit banking, or for anything like it—they were founded for much more pressing reasons, and having been founded, they, or copies from them, were applied to our modern uses," he speaks truth, but the student of banking must remember the paradox that banking was in practice before banks were founded at all.

Three Causes of Origin.

Since this book does not purport to be a history of banking, we must content ourselves with examining in some detail for our own purposes the rise of banking in one State only, and that State our own. It would seem that three main causes operated to produce the modern banking system. There was in this country, as there had been in Italy, where banking was first given its name, the need for companies to arrange and make loans for and to the State, as there was need for men to lend to harassed private citizens. There was in the rural areas a need for some means of mobilizing the credit of the farmers, whose crops took time to grow and to market. In those areas some rich man, probably a local cloth-weaver or a brewer, or even a small squire of inherited reserves of wealth, whose own credit was high with all in his neighbourhood, would assist his less fortunate fellows. Such a one would issue his personal notes which he undertook to honour when presented, counting on some delay before presentation. His credit being high,

the notes he issued would pass from hand to hand and would become, in effect and use, a local currency. The issuer of such notes would, of course, be receiving interest on his loan for the whole period that the notes circulated, but would be paying none. Small men in his area wishing to start new enterprises or to extend older ones would come to him for the necessary capital, as my friend John Doe, finding my occasional pound inadequate, might have gone to a wealthy man for more money with which to employ his carpenter longer hours and with which to buy more wood for the article which he found he could sell at such good profit. Going for money to such a man for such a purpose, John Doe, or his rural equivalent, would not suggest giving the lender a share of his profit, but would offer to pay what interest the lender demanded, with the mental reservation that should the rate prove higher than profit allowed, he would not borrow. The wealthy neighbour might give him for his temporary use either official currency or merely his own notes of hand, which would in that area be circulating as an unofficial local currency. The rich man who lent by means of his own notes was employing none of his own actual capital, but was actually lending at interest his personal credit.

The Goldsmiths.

The third practice which was to become a contributory stream in the history of modern banking was confined to the urban settlements. In London, and no doubt in the bigger provincial towns, such as York, there were goldsmiths whose commodities were of such a tempting nature to thieves that they had been compelled in self-protection to devise adequate means for guarding their treasures. As the late Dr. Walter Leaf in his monograph

on *Banking* (Home University Series) has concisely described the process, from the goldsmiths' measures of safety developed a new form of service, for as the goldsmiths

> " . . . had been bound to make a special study of the safe custody of their own valuable assets (they) were ready to offer their services to those of their customers who had either cash or other valuables which they wished to keep in greater safety than their own houses could offer. Hence had arisen a custom of depositing with the goldsmiths any cash which was not needed for the moment, to be repaid at some date in the future. It was evident that cash thus deposited could be re-lent at interest, so long as it could be called in by the time when repayment was required ; and it was worth the goldsmiths' while to offer a moderate interest on money deposited with them for a fixed time, relending it at a higher rate of interest for a corresponding period. As experience grew, it was found that it would be safe to reckon on a certain proportion of the total deposits being left in practical permanence, at all events while business was running smoothly ; it could thus be lent out at interest without regard to any conditions as to the fixing of the period for which deposits were made ; in other words, money could be taken on deposit repayable on demand, and yet a certain proportion could be lent for short periods with safety. Thus there came into being the ' current account ' withdrawable on demand, and following upon this the introduction of the cheque as a transferable instrument."

The fulfilment of three obvious needs felt by the community thus created three new functions, and in our own time the performance of those functions has centred itself upon the banks as we know them. Before discovering how the original " finance company " banks, formed to make loans to Governments, the rural bankers and the city goldsmiths gave place in time to **Private Banks, Joint Stock Banks, Banks of Issue**, and **Central Banks** throughout the English speaking world, we must look also at another ancient function which early banks performed.

Sound Coin.

In Northren Europe, about the beginning of the seventeenth century, the traders and merchants found themselves hampered by the independability of the coin which circulated

" The currency of a great State," wrote Adam Smith in what Bagehot calls an admirable description, " generally consists almost entirely of its own coin. Should this currency, therefore, be at any time worn, clipt, or otherwise degraded below its standard value, the State by a reformation of its coin can effectually re-establish its currency. But the currency of a small State, such as Genoa or Hamburg, can seldom consist altogether in its own coin, but must be made up, in a great measure, of the coins of all the neighbouring States with which its inhabitants have a continual intercourse. Such a State, therefore, by reforming its coin, will not always be able to reform its currency. If foreign bills of exchange are paid in this currency, the uncertain value of any sum, of what is in its own nature so uncertain, must render the exchange always very much against such a State, its currency being, in all foreign States, necessarily valued even below what it is worth.

" In order to remedy the inconvenience to which this disadvantageous exchange must have subjected their merchants, such small States, when they began to attend to the interest of trade, have frequently enacted, that foreign bills of exchange of a certain value should be paid, not in common currency, but by an order upon, or by a transfer in, the books of a certain bank, established upon the credit and under the protection of the State, this bank being always obliged to pay, in good and true money, exactly according to the standard of the State. The banks of Venice, Genoa, Amsterdam, Hamburg, and Nuremberg seem to have been all originally established with this view, though some of them may have afterwards been made subservient to other purposes. The money of such banks, being better than the common currency of the country, necessarily bore an agio, which was greater or smaller, according as the currency was supposed to be more or less degraded below the standard of the State. The agio of the Bank of Hamburg, for example, which is said to be commonly about 14 per cent, is the supposed difference between the good standard money of the State, and the clipt, worn and diminished currency poured into it from all the neighbouring States.

"Before 1609, the great quantity of clipt and worn foreign coin, which the extensive trade of Amsterdam brought from all parts of Europe, reduced the value of its currency about 9 per cent below that of good money fresh from the Mint. Such money no sooner appeared than it was melted down or carried away, as it always is in such circumstances. The merchants, with plenty of currency, could not always find a sufficient quantity of good money to pay their bills of exchange; and the value of those bills, in spite of several regulations which were made to prevent it, became in a great measure uncertain.

"In order to remedy these inconveniences, a bank was established in 1609 under the guarantee of the City. This bank received both foreign coin and the light and worn coin of the country at its real intrinsic value in the good standard money of the country, deducting only so much as was necessary for defraying the expense of coinage, and the other necessary expense of management. For the value which remained, after this small deduction was made, it gave a credit in its books. This credit was called bank money, which, as it represented money exactly according to the standard of the Mint, was always of the same real value, and intrinsically worth more than current money. It was at the same time enacted, that all bills drawn upon or negotiated at Amsterdam of the value of six hundred guilders and upwards should be paid in bank money, which at once took away all uncertainty in the value of those bills. Every merchant, in consequence of this regulation, was obliged to keep an account with the bank in order to pay his foreign bills of exchange, which necessarily occasioned a certain demand for bank money." (*Wealth of Nations*, Book IV, chapter III.)

One other function the banks arose to fill, and still perform, which was the remitting of money. Of this we shall learn more when we reach the study of the foreign exchanges.

§ 2

By the beginning of last century the goldsmiths of London had given place to deposit banks—known as private banks—which flourished by attracting to themselves the deposits of citizens and traders and using them

to finance other citizens and traders who were in a position to offer reasonable security. Reasonable security consisted in trade bills, which the banks discounted—see page 69 above—or goods in the process of sale upon which the bank could establish a claim in case of default, or upon securities which were dealt in upon the Stock Exchange. In addition to these the banks also lent money or credit upon the deeds of buildings and sites, but such security was only accepted in small proportion to other forms since loans so made could not be realized at short notice. "The only securities which a banker, using money that he may be asked at short notice to repay, ought to touch, are those which are easily saleable and easily intelligible—if there is a difficulty or a doubt, the security should be declined," was a maxim laid down by a nineteenth century authority, and followed both before and after its terse formulation by most successful bankers.

The Bank of England.

In 1694 had been founded the Bank of England, owing its origin, as had the earlier Italian banks, to a Government loan. By the beginning of the last century it was a flourishing joint-stock bank—that is, a bank working for the profit of shareholders in its enterprise—with the privilege of carrying the Government account and having, by usage, the sole right to issue notes in the Capital. By the Charter of 1708 the Bank of England was popularly supposed to enjoy a monopoly of note issue in London on the strength of a provision which read as follows—

> "During the continuance of the said corporation of the Governor and Company of the Bank of England, it shall not be lawful for any body, politic or corporate whatsoever, created

> or to be created (other than the said Governor and Company of the Bank of England), or for any other persons whatsoever, united or to be united in covenants or partnership, exceeding the number of six persons, in that part of Great Britain called England, to borrow, owe, or take up any sums of money on their bills or notes, payable at demand, or at a less time than six months from the borrowing thereof."

But outside of London the country possessed numerous small private banks which, having fewer than six partners, did issue notes. After the date of the Charter the private banks found, somewhat to the surprise of contemporary theorists, that deposit banking even without the right of issue could be an exceedingly profitable business. The London banks, even those with fewer than six partners, continued to work in alliance with the Bank of England, refraining from issuing notes where the right was possessed. Joint-stock banking, however, did not become common until in 1822 to the knowledge that note issues were not essential to banking profit was added the tardy realization that the Charter of 1708 did not prohibit joint-stock banking as such, but only joint-stock banking which included issue. In 1826, legislation was passed which expressly conferred the right of companies of more than six partners to carry on the business of banking outside a 65 mile radius of London, provided no establishment were maintained in the capital itself. Not only could such bodies issue no notes within that radius, but they could not draw bills on London for sums of less than £50.

The Charter of 1833.

The position became clarified with the renewal of the Bank's Charter in 1833. For three decades the industrial revolution had been at work upon the social and business habits of the nation. Population had increased and

manufactures had enormously expanded. The strain which had been thrown upon credit and commercial systems by the Napoleonic wars had caused them to change somewhat, but they were in 1825 unable to face the demands upon them. It was a panic of unusual menace which forced the Act of 1826 to which we have just referred, and it was the obtrusive needs of a rapidly multiplying commercial community which forced the further concessions of the Charter of 1833. This document admitted the doubts which had arisen as to the construction of previous enactments affecting banking, and while it reiterated the exclusive privileges under such Acts of the Bank of England, it further enacted that,

> " . . . any body politic or corporate, or society or company or partnership, although consisting of more than six persons, may carry on the trade or business of banking in London or within sixty-five miles thereof, provided that (they) do not borrow or take up in England, any sum or sums of money on their bills or notes payable on demand or at any less time than six months from the borrowing thereof."

The Act of 1833 had an immediate effect. The removal of the prohibition of London establishments caused the London and Westminster Bank and the London and County Banking Company to be established early the following year, and brought to London such older establishments as the Midland Bank, Lloyds Bank, the National Provincial Bank, and Barclays, the two first from Birmingham, the third from Gloucester and the last from the Eastern Counties.

This influx was not welcomed either by the Bank of England itself or by the existing private bankers in the Capital. London bankers, finding expression in the mouthpiece of Lord Overstone, prophesied both the speedy ruin of the joint-stock banks and a reaction of

panic throughout the country from that ruin. The joint-stock bank was so suspect that the most extravagant things were freely prognosticated upon no basis but that of prejudice. In 1833, Overstone (at that time still plain Samuel Jones Loyd) gave evidence on the working of the Bank Act before a Parliamentary Committee, subsequently publishing his evidence as a forerunner to his *Reflections on the State of the Currency* which appeared in 1837 and led, as we shall see, to the Bank Act of 1844. The fervency with which he advocated before the committee of 1833 his belief in a non-multiplication of the issue of paper money, a solitary bank of issue, and the regular publication of the accounts of the bank reserve, reflected the emotionalism which had made his father a dissenting minister before he became a banker and a founder of the very bank which was eventually, as to its London branch, to be absorbed by the London and Westminster, the first of the new joint-stock banks to take advantage of the Act of 1833.

Overstone's Influence.

Overstone (whose later title is used rather than his then name for convenience of identification) was able to secure in high places considerable support for his views. His influence enabled the Bank of England in 1837 to obtain an injunction against the London and Westminster "prohibiting their accepting any bills drawn at less than six months after date." This was designed to end the bank's country connection, but James William Gilbart, with characteristic ingenuity, as manager of the London and Westminster, persuaded the country banks to draw on his establishment bills "without acceptance" and circumvented the attack. (Readers to whom such phrases as "acceptance" and "to draw a bill" are still

unfamiliar will find them explained later, and for the moment will understand the context without definition.) In 1840 Overstone again uttered his views to a Committee of the House of Commons on banks of issue, again publishing his evidence as a pamphlet.

Despite some opposition, those views carried great weight, particularly with Peel, the Prime Minister, and were the basis of the Bank Act of 1844. By this Act the right of note issue for even country banks was restricted and provision made for its gradual extinction. The country banks which came to the Capital had to forgo their issue right and no new banks of issue were to be allowed to commence business.

Bank Act of 1844.

There is a good short survey of the scope of the Act of 1844 to be found in Dr. A. A. W. Ramsay's *Life of Sir Robert Peel*, part of which may be noted with benefit here.

> " . . . . The inventions of the industrial revolution had made almost unlimited production possible ; but production had been hindered by the difficulty of distribution, by artificial restrictions on trade, and by the degradation of the working classes, which diminished their power of consumption. Now Peel removed the restraints on trade and transferred the burden of taxation from the poor to the upper and middle classes, and almost at the same moment the means of cheap and rapid distribution were provided. British trade and industry received an impulse which was hardly to be checked for forty years.
>
> " In the meantime Peel had introduced a further measure of currency reform. In 1844 the Charter of the Bank of England came up for revision, and he seized the opportunity to frame new regulations, which he hoped would prevent the recurrence of those periodic financial crises which had been so disastrous in the past."

His hope was to prove a little too sanguine, as events showed, but, if the crises were not prevented, they were,

at least, reduced in number and lightened in their incidence. Dr. Ramsay proceeds to describe the effect of Peel's new legislation—

"The Bank Charter Act of 1844 was drawn up under the advice of Loyd Jones,[1] afterwards Lord Overstone, himself a great banker. It divided the Bank of England into two departments, rigidly separated. One undertook the ordinary banking business; the other dealt with the issue of notes. The bank was allowed to issue notes against securities to the value of £14,000,000. Beyond this sum all issues must be made against coin and bullion, and the treasure of the Banking Department was not to count as part of the Issue Department's reserve.

"The right of the country banks to issue was strictly limited, and no new banks of issue might be created. If any country bank surrendered its right of issue, the Bank of England might increase its own issue against securities by two-thirds of the amount surrendered.

"The Scottish banking system Peel greatly admired, and he did not wish to disturb it. He merely limited the right of issue against securities to the average amount of the current year, and all notes beyond this must be issued against coin or bullion.

"The Act did not touch the ordinary banking business of the country, which Peel thought should be left to private enterprise like any other business. It is usually said that the object of the Act was to secure the convertibility of bank-notes, but it is more correct to say that it was to prevent the undue expansion of the currency. This is not a distinction without a difference: the Act did secure the convertibility of notes, but it did not prevent undue inflation of credit.

"Peel 'had been so strongly impressed with the evils of over-issue, the most dangerous of the abuses to which banking is liable, which had displayed themselves with extraordinary violence between 1836 and 1839, that he became almost blind to any other considerations.'

"In 1847, 1857, and 1866 financial crises occurred, almost as severe as those of 1825 and 1836. In each of these cases the Act of 1844 was suspended. Large demands for credit were made on the Bank; the reserve fell very low; the Bank

[1] Overstone was the son of the Rev. Lewis Loyd and Sara Jones. The Welsh frequently place the mother's maiden name after the paternal surname. Overstone is thus known as Loyd Jones and Jones Loyd according to the authority quoting or mentioning him. I follow the English custom and call him Loyd.

represented to the Government that a crash must come unless they could issue notes beyond the authorized limits; and the Government promised to introduce into Parliament a Bill of indemnity if the Bank did so. The Government's letter was usually enough in itself to abate the panic, and only in 1857 was it actually necessary to issue extra notes. In each case the Bank Act aggravated the difficulty in the final crisis by limiting the issue of notes at the very moment when credit was most urgently needed; while it failed to prevent an over expansion of credit at the beginning of the crisis."

The weakness of the Act of 1844 in times of crisis was that it affected only the issue of notes, and did not affect the extension of other forms of bankers' credits, such as bills of exchange and cheques. When these other forms of credit failed, then came the demand for notes, and then —at just the wrong moment—the Act limited their issue.

Justification of the Act.

What the Act of 1844 failed to accomplish, the growing mastery of the science of banking did in time achieve. From 1866 no crisis comparable to those of the earlier years disturbed British banking. There was the menace of crisis in 1890, averted by the wisdom of the then Governor of the Bank of England, and there was something of a crisis in 1907, from which America suffered severely. There was also the inevitable crisis in 1914 at the outbreak of war, but that was overcome by the exceptional measures upon which the Bank and the Government agreed and was in reality the inauguration of a new era in finance and banking.

Despite its weakness the Act of 1844 did, however, achieve its main purpose. During the eighty odd years in which it governed British banking, the country established itself with such solidity that London was not ousted even by the assaults of the Great War from its position as

the money market of the world, a position from which the post-war rise of New York has not dislodged it.

During the eighty-four years which followed the Act of 1844, the history of English banking may be summed up, in the words of Dr. Leaf, in the extension of the deposit system to joint-stock banks and the absorption by them of the private banks, " a process which is now complete, for all practical purposes, so far as the country is concerned, and almost complete in London."

§ 3

The difference between the days when goods and valuables were deposited with the goldsmiths for safety and our own day, when they are deposited with the bankers for use, is more than a difference in practice. The whole psychology of both bankers and depositors has altered. It has involved, curiously enough, a growth of confidence in the users of banks and a diminution of confidence in the bankers. So timid were depositors at one time that certain European bankers kept a careful record of the actual coins deposited by the peasant clients, says Professor Agger, in his *Organized Banking*, and saw to it that exactly the same denominations were returned. " This was done because the peasants nourished the fond delusion that the banker simply locked away in his strong safe the money-bags that they brought to him, and that the bags were subsequently returned to them intact. They would not have entrusted their money to bankers had they believed otherwise. It was obviously to the banker's interest to preserve this delusion." Depositors are no longer so ingenuous, and the banks have reached such a pitch of security that it is everywhere realized that to deposit money with a bank is almost to

eliminate all risk of its loss, certainly to reduce the possibility of loss to such an extent that it need no longer be taken into consideration. This confidence is reinforced by the knowledge that in our own time no one bank would be allowed to meet disaster without the others' coming to its rescue, and that, rather than allow any catastrophe to shake the public faith in the system, the State would come to the aid of the banks if they were jointly menaced by crisis.

So wide has become the habit of depositing money with banks that even the most ignorant and humble members of society turn instinctively to the Savings Banks as a protection for their own meagre accumulations. The Post Office Savings Bank, the Yorkshire Penny Bank, and others, play a very important part in the social life of the English communities, and it may be worth while to anticipate our next chapter, which examines the true function of the banks and their methods of filling it, and look for a moment at the particular function filled by the savings banks.

Savings Banks.

We have seen that the prime function of modern banking is to mobilize cash and credit. The savings banks confine their attention to funds which are temporarily not needed by those accumulating them, but which are required to be kept in a semi-liquid form. The small wage earner, for example, has a margin of income over expenditure which he wishes to accumulate against a special need. He may be saving towards the expense of establishing himself in a home of his own, or towards the buying of Christmas cheer, or for any other object of a like personal nature. He does not require the return of his funds "on demand," but is able to give some

notice to the bank of his intention to withdraw. Since his main intention is to have his savings guarded, he is content with a low rate of interest upon them. In a community where thrift is encouraged, and despite the inroads made by the various means now afforded of making actual purchases by instalments (discussed at some length in the later sections of this volume) or of investing small sums in other ways, the deposits of a savings bank usually exceed by a fair margin the withdrawals of which ample notice is given. The funds deposited can therefore be invested by the bank in securities chosen rather for their safety than for their easy release. The maxim that bankers should not touch securities which are not easily saleable thus does not apply to this form of banking business, and the investments chosen by the savings banks are, as often as not, mortgages and municipal loans. It is in the mobilization of a multitude of small funds for purposes of long term investment that the savings bank finds its true purpose.

But while the increasing confidence of the public in the security and stability of the banks has marked the passage of the last hundred years, the very augmentation of depositors has caused the banks themselves to appear less ready to extend their own confidence, and for good reasons. When the private bank in the country was still the business of some wealthy person who dominated the neighbourhood, and who had become a banker rather by the natural extension of his friendly actions than by deliberate intention (see page 85 above), a member of the local community desiring a loan in order to tide him over harvest time or to extend his own business was frequently not asked to give any material security. Since he was known to the banker, he was allowed credit on his personal prestige as a man of

integrity and industry. The risk taken by the banker was personal, and the knowledge of the borrower was personal. In some cases the banker would allow a loan from motives of sheer friendship and altruism, granting money to some neighbour whose affairs were just on the turn, and who might as easily lose all as recover all by the application of fresh capital. I have myself talked to more than one prosperous trader in the North of England whose fortunes were founded in a previous generation by just such action on the part of men like the founder of Beckett's Bank in Yorkshire, or of Williams Deacon's Bank in Lancashire.

Power of Local Manager.

Even when the private banks became absorbed by the joint-stock banks, such personal risks were still possible and still taken, but as the banks became more and more responsible to a larger and larger body of shareholders, such altruistic or unsecured risks were obviously taken less and less frequently. In our own time the areas served by a bank are very often completely out of touch with the final authorities who decide upon the granting of large credits; the local branches, with their local Boards and their local managers, cannot maintain anything like the old personal contact with customers, who have become too numerous to be retained in the mind as individualities each with a personal history known in detail; the businesses asking for accommodation have themselves very often ceased to be personal, and, even if personal, are limited companies. Accommodation for these reasons must be limited and adjusted by the tangible security which a customer can offer, if the amount required is a sum of any magnitude.

This is not to say, as many foolish people do say, that

the modern bank manager has become a mere automaton. The depositor with a relatively small current account is still able to approach with confidence his local manager and receive from him temporary accommodation on the strength of his known integrity and position, and even the larger credits are given or refused by the ultimate authority—be it a local or a national authority—on the strength of the manager's recommendations based on his knowledge of local personalities and conditions.

CHAPTER VI

BANKS AND THEIR FUNCTIONS

WE have seen in previous chapters the nature and use of money, the nature and use of credit, and the way in which there arose specialists in the handling and organization of both these media of exchange. We may now safely attempt a definition of a bank, although no definition can be all-inclusive, but must, like our definitions of money, be varied by the context in which the word is used.

A bank is an institution which receives deposits and extends credit. Banking is an activity by which the credit of a community is organized in order to facilitate exchange, stimulate production and conserve capital.

How, it may be asked, is exchange facilitated? As we saw earlier in this book, barter, or direct exchange of commodities and services, is a method which it is inexpedient for any but a small and limited community to attempt, since needs do not often and exactly coincide. The alternative to barter is the use of some commodity as a medium of exchange. But in the complicated exchanges of a congested and intricate community such an alternative is itself so clumsy as to be impracticable. If, for a moment, it is estimated what bulk of gold and silver would be needed to permit all modern commercial interchanges to be financed by payments in bullion or coin, the impracticability will be apparent. The credit system enables us to substitute for coin or commodity a mere promise to pay. Promises to pay may take one of several forms, but when "generally acceptable"

and passed from hand to hand they function as a kind of unofficial currency. But that unofficial currency must sooner or later be redeemed. The various promises to pay which a man has issued and the promises to pay which he has received must to some extent cancel each other out. By providing a clearing house in which a man's obligations and claims are brought together for cancellation and settlement, the banking system facilitates the use of such promises, i.e. it facilitates exchange.

How, next, is production stimulated? Production is stimulated by the simple expedient of providing the financial means for production in anticipation of the actual demand for the commodities produced. This anticipation of demand is highly necessary in the state of civilization in which we live. When we borrowed from Sir Ernest Benn, in Chapter II, an account of how a shilling expended upon a collar brings together the goods and services of men in all parts of the globe, we saw the pitch of specialization to which the modern world has attained.

That specialization, however, leaves a long gap of time between the inauguration of the first effort and the payment by the user of the finished product. The man who, in Russia, sowed the flax, and the engineers in Germany and America who made the machines to be used in Leicester, did their work a year or two before the collar was bought and paid for, and even the retail tradesman from whom it was purchased and the wholesale tradesman from whom he himself had purchased it, had waited some time between the satisfactions derived from the passing of the shilling over the counter in the Strand and the assumption by them of responsibility towards others in the long chain of relationships. All the persons concerned relied upon the shilling (and other

shillings) being paid to reimburse them for their own expenditures—but they had to make those expenditures long before the shillings were available. Either each one of them must have had resources or must have been able to procure means whereby his share of the complicated transaction could be performed. Some, no doubt, had savings. Others, no doubt, had incomes from the sale of previous goods or services. But many would require to mobilize their credit in support of their efforts to have my collar waiting for me in the shop in the Strand when I wanted it.

Conservation of Capital.

This mobilization the banks effected. In doing so they incidentally released the various producers from the handicaps placed upon them by the irregularity of natural conditions and of demand. The peasant could produce flax, and the engineers machinery, without themselves worrying as to whether their products would be needed when they were produced. Wholesalers and retailers, shippers and merchants, being enabled to wait until the demand for the finished collar materialized—instead of waiting for the demand before instigating the making of collars—took from all the contributory streams of effort the production which offered itself, and took it as it came, no matter what the extent of the crop of flax or what delays on the high seas affected the quantities of raw material delivered.

The conservation of capital by the simplification of exchange, and the specialization of function which the banks make possible will be obvious, and may be indicated by reference to only one saving, that occasioned by the incessant use of implements for one purpose by specialists, instead of capital resources being employed

by many persons to duplicate such implements for casual use. If we all made our own collars we should all use a blade of sorts for cutting our material. Each blade would require the use of capital. One specialist cutting many collars uses, if not one, certainly very few blades to effect a vast supply of the ready-cut material to the next specialist.

§ 2

We pass now to the question, How does a bank receive deposits and how does it extend credit ? This involves the question, What is a deposit ?

If I enter my bank—there is, by the way, a world of significance in the general habit which all users of banks contract of speaking of the institution as if they owned, instead of merely used, it—if, I say, I enter the bank of which I make use, and pass over its counter a sum of money, I have deposited that money. If, similarly, I pass over the counter a number of credit instruments giving to me an acknowledged claim on the money of other persons, I have, to all intents and purposes, deposited a sum of money equal to the total of those instruments. The bank places to my credit in its ledgers the amount of the money, or of the money equivalent, which I have deposited. My deposit with the bank is, in one sense, therefore, a sum of money standing to my credit with the bank.

Actually, as we know, there is not in the strong-room of my bank a sum of money in safe custody deposited by me. My deposit is thus merely an entry made in the books of the bank, recording my right to demand from the bank the sum of money to which I am entitled by the lodgment at different times of either money, or claims upon other persons for money.

A Deposit Defined.

Very rarely does the average depositor exercise the right, which he has established, to demand money. His usual use of that right is to transfer it in part to his creditors. **A deposit may be defined, therefore, as an admitted right to demand or to order payment of a given sum of lawful money.**

Banks attract deposits in two ways, by offering safe custody and by offering a payment for the use of money entrusted to them. But these two attractions seem mutually exclusive, since money in use cannot be in safe custody. How are they reconciled? We have said that depositors rarely exercise their rights to demand money, preferring to transfer in part or whole their right to others, who, similarly, may not demand money. It is not necessary for any bank to hold in actual cash an amount equal to or even approaching the amount of the total of its deposits. It holds merely a fraction of that amount. The cash which it does hold is known as **the reserve**, and the use made of that reserve we shall examine in due course.

Since the bank has admitted the right of the depositors to demand cash, and since at some time or other each will want to exercise his right, every deposit is, from the viewpoint of the bank, a liability. When I handed over the counter my sum of money or my accumulation of credit instruments from other people, the bank in its ledger, as we have seen, placed the amount to my credit. I became to that amount a creditor of the bank, and the bank became my debtor. Had I wished, I could have kept my cash or have transformed the credit instruments into cash. I did not do so because cash was less convenient to me than the knowledge that the bank would always give me my cash, or any portion of it, on demand,

would transfer it for me to anyone I might name, or would pay me for being allowed to use it. The cash was less convenient for many reasons, chief amongst which stand the facts that if I kept any large quantity of cash about my house or person I might lose it, by theft or misfortune; that I could not easily transfer cash to my more distant creditors; that cash is bulky stuff to carry about, and that if I kept cash it would be sterile, whereas by leaving it with a bank it is made fruitful, and of its fruits the bank, the community and myself take each a share. The "deposit" which stands to my credit at the bank is in every way the more convenient form of possession, although it would not be so if I had not the firmest faith in the stability and integrity of the bank. As we saw in Chapter IV, credit lives up to the origin of its name, and is belief, in its naked form. I believe in the bank. Those with whom I have dealings believe in the bank. We do not therefore ask for cash, but take the bank's admission of our respective rights instead of coin.

A Right of Demand.

When I have made a deposit, what has the bank actually done? It has accepted my cash and has given me the right to demand cash at some future date. It has sold to me for cash a right of demand, just as a young lady at a bazaar might sell to me for cash the right to demand refreshments in the café chantant. I have sold my cash for a right. The bank has sold a right for my cash. Obvious and trivial as this statement of the transaction may seem, it is important, for once the sale has been made I have no legal right to my own cash. To stress the position with an absurd example, if I deposited cash containing a coin upon which, for some sentimental reason, I placed a special value, I could not, even two

minutes afterwards, demand its return as a right. The cashier, as a favour, might find it for me and return it, but legally it has become the property of the bank. If this were not the legal effect of such a transaction, the practice of keeping but a small reserve against demands and the practice of using all deposited funds indiscriminately, would become dangerous.

The banks, having attracted deposits, receive them in several ways. One depositor will deposit cash, that is coins or currency notes. Another will deposit bank-notes, another cheques or drafts drawn either on his own bank or on other banks or on persons, and another will persuade the bank to discount bills or to make him a loan on some security. The man who deposits cash has bought for cash a right to demand cash. The man who deposits cheques and drafts has effected an exchange of credit. By what means has he effected this exchange ?

In the old days when a citizen deposited his valuables with the goldsmith he knew that to recover them he had only to send to the goldsmith's shop a properly authorized messenger who would present his credentials and receive the valuables. Falling back upon conjectural history, it is impossible not to suppose that it must often have happened that part of the valuables deposited were wanted before the owner wished to recover the whole. A man may have sent his son, or his servant, or his clerk, with a note to the goldsmith saying, in effect, " Please give to this messenger the two silver porringers which you are keeping for me." A man may even have sold to some friend part of his stored valuables, in which case he would send a message saying " Deliver to Mr. So-and-so the twelve silver spoons which you have in your keeping." The goldsmiths found that when cash was left with them they could lend it out at interest because all the depositors

would not want their cash at once. By encouraging depositors to draw on them only for portions of the total amount stored, they laid the foundations of modern banking, as we have seen. They also brought into use "drawn notes." From drawn notes was evolved the cheque, first used as a term in the middle years of the eighteenth century. The difference between the drawn notes and cheques was that cheques became negotiable, that is transferable, instruments. When deposits were drawn upon at will the account of the depositor was transformed into what we know as a current account, and the drawings were facilitated by the use of cheques.

Use of Cheques.

Prior to the introduction of cheques, the goldsmiths had brought into use "goldsmiths' notes," which served as an unofficial currency until the repudiation of a debt by Charles II caused them to become unredeemable, owing to lack of reserves. From this setback to early deposit banking the cheque gave a means, not only of recovery, but of positive and remarkable advance.

A cheque is a valid order to a bank by a depositor to pay to the person named on the face thereof, or to his representative or order, or to bearer, the sum specified by the drawer. To be valid a cheque must obviously be legally drawn. To be legally drawn in this country (England) it must bear on its face a stamp of a certain value in payment of tax. At the time of writing English cheques bear a stamp of 2d. value. At one time—and probably at some distant date again—a 1d. stamp would suffice to meet the demands of the national exchequer. This is not to say that an order to pay is not to be honoured by a bank if it lacks a stamp. Rhodes frequently sent down to his bank at the Cape cheques written on odd pieces of paper, and once,

I am told, a cheque drawn on a piece of fabric from a shirt. But on the transaction by cheque 2d. must be paid to the revenue, and it is of no consequence whether the cheque is drawn on stamped paper or on paper afterwards stamped. The usual form of a cheque is simplicity itself. It bears a place and date line followed by the order to pay and the signature of the drawer. It usually also carries a serial number for the convenience of the bank officials.

No. N18150. LONDON.
1st July, 1929.

BROOKS'S BANK LIMITED
LONDON

Pay .... *A. N. Other* .... or order
Five pounds, ten shillings and six pence

(*Signed*) D. E. POSITOR.

£5 10s. 6d.

Let us suppose that the above cheque has been given or posted to Mr. A. N. Other, that celebrated county cricketer, who wishes to deposit it at his bank. (The name of the drawer, Mr. D. E. Positor, would be, of course, a signature.) Mr. A. N. Other writes his name across the back of the cheque. That is his **endorsement.** It constitutes his own order. Had the cheque been made out to Mr. A. N. Other or bearer, such endorsement would not have been required, since any one presenting the cheque at the counter of Brooks's Bank would have received the money to which he was entitled. Having endorsed the cheque, Mr. A. N. Other literally deposits it at his own bank. Since it now bears his order, and his

own bank, the Bank of Muddleborough, Limited, can obtain cash for it, it is equivalent, so far as Mr. Other is concerned, to a cash deposit. But had Mr. Other, by lucky hap, had his own account with Brooks's Bank, what would have happened? The bank having to the credit of Mr. Positor a sum of £100 10s. 9d., and receiving an order to pay Mr. Other a sum of £5 10s. 6d. has merely to add that amount to Mr. Other's account in the books and subtract it from Mr. Positor's account, leaving Mr. Positor's total deposit at £95 0s. 3d. The bank has transferred a credit from one to the other of its depositors.

The Clearing House.

That Mr. Other banks not with Brooks's Bank but with the Bank of Muddleborough involves a little more trouble, but no change of principle. Mr. Positor, having the right to demand money from Brooks's Bank, passed it to Mr. Other, who passes it to the Bank of Muddleborough. The Bank of Muddleborough credits the account of its depositor, Mr. Other, with a new deposit of £5 10s. 6d., and presents the cheque to Brooks's Bank. Brooks's Bank may employ cash to meet the cheque, but is not likely to do so, since the banks have a joint **Clearing House**, where all orders to pay given to and received by the various banks are compared, the collections balanced against the disbursements, and only the differences settled by cash. But whether Brooks's Bank uses cash or, using the Clearing House, finds a call upon the Bank of Muddleborough to balance Mr. Positor's cheque, it debits Mr. Positor's account with the amount stated. That is, it lowers his credit with the bank by £5 10s. 6d., which is the amount by which Mr. Other's credit has been raised by the Bank of Muddleborough.

Again, all that has happened has been an exchange of credits.

In making out his cheque Mr. D. E. Positor, being a well-trained bank user, did not embellish the name of Mr. A. N. Other with any conventional adornments or marks of distinction. He did not instruct the bank to pay Captain A. N. Other, D.S.O., M.C., or to pay A. N. Other, Esq. When Mr. A. N. Other endorsed the cheque he, being equally well trained, took care to endorse it exactly as it was made out to him. He did not sign across the back the name (which would have been accepted by his bank as a good endorsement) Anthony Norman Other, or A. Norman Other, or Anthony Other, or—if he did—he wrote above it the name as it appeared on the face of the cheque, endorsing it: A. N. Other. Anthony N. Other. His endorsement was, as we have noted, his own order. The cheque instructs Mr. D. E. Positor's bank to pay A. N. Other or order. Mr. Other's " order " must accordingly be made in the name of A. N. Other, despite the fact that his sweetheart calls him Tony, his friends Norman, and he usually signs himself as A. Norman Other.

The cheque which Mr. D. E. Positor gives to Mr. A. N. Other is an order to Brooks's Bank to pay cash, but it is more than likely that Mr. Other will not want cash, and it is safer for both of them if the cheque is drawn in such a form that the demand for cash cannot be made on it by a rogue who may steal it, or a conscienceless person who may find it. In other words, it may be more convenient to both if Mr. Other is compelled to treat the cheque of his friend as a potential deposit. In England the **crossed cheque** has this effect. Two lines drawn across the face of the cheque prohibit the holder from obtaining cash on demand across the bank counter. Crossing a cheque does not impair its use as a transferable

instrument. It may still pass from hand to hand. If, however, it is desired to prevent its use in this way, the drawer has merely to write between the two lines of his crossing "account payee only" and the bank will then only credit the person in whose favour it is drawn. Similarly, the drawer may specify a particular account in the same manner. Cheques to official bodies are often drawn in favour of an official and crossed in favour of a certain account. Mr. D. E. Positor may thus instruct his bank by cheque to pay the Collector of Taxes, and may cross the cheque "Inland Revenue Account." In Germany there are two forms of cheque, a pink and a white. On the white cheque cash is never paid. In times of panic America used a cheque marked "payable only through the New York Clearing House," and on such cheques cash was not paid. It must be remarked that when a cheque is crossed the refusal to pay cash is that of the depositor, not that of the bank. The bank, in theory, is always ready to pay cash, and if cash is withheld, it is by reason of an instruction from the person owning the original right to demand it.

Severe Limitations.

It will be realized that as a means of transferring rights of credit or rights to cash, the cheque is subject to very severe limitations. It is a medium of exchange only in so far as it is acceptable. I may order a bank to pay to some other person a given sum, but my order is no guarantee that I have that sum to my credit in the bank named. The cheque may be worthless, inasmuch as I have never had an account at the bank, but have by low cunning secured an official cheque form; or it may be worthless, inasmuch as I have previously exhausted my credit there by drawing other cheques upon my account.

If I am of known substance and integrity the acceptance of my cheques by those knowing me will be willing and ready, but if I am of doubtful character or dubious means it will be neither ready nor willing. It is true that the law has provided certain deterrents against the issuing of worthless cheques, but a deterrent is never an absolute preventive, as witness the effect of capital punishment upon potential murderers. To our definition we must accordingly add the rider that **a cheque is an instrument of limited acceptability.**

In addition to the element of risk in the acceptance of a chequewhich arises from the possibility that the drawer may either have but a depleted account or no account at all with the bank, is the second element of risk arising from the possibility—rare and remote, but always present in theory—that between acceptance and presentation the bank itself may have become unable to meet the demand upon it. The depositor who draws a cheque obviously has faith in his bank, or he would not deposit with it, and the person accepting the cheque obviously has faith both in the depositor's bank and the depositor himself. The confidence of both is retained by the bank partly by reason of the bank's impalpable prestige and partly by the known fact that it possesses an adequate reserve.

The greater the confidence in the bank and the greater the use of cheques as a means of transferring credits rather than cash, the less the need for a large reserve. The fewer the number of depositors which a bank has, the larger the need for reserve, for, although the few may deposit greater values than the many depositors of some rival bank, the probability that all or a majority of them may wish at the same time to withdraw their deposits is greater.

§ 3

Having adopted the viewpoint of the depositor using cheques as a means of transferring to others his cash or his credit, we can now, with benefit, move for a while to the other side of the bank counter. From that standpoint, how do we view the reserve which we have hitherto regarded only as an assurance that our confidence in the bank is sound ?

A bank does not organize credit only by means of transferable deposits. It also uses notes. A deposit bank is not, as we saw in an earlier section, a bank of issue, but none the less it uses the bank-notes which come from the Bank of Issue. (The mode of its use will be examined later.)

The bank-note differs materially from the cheque, for whereas the cheque is an order by one depositor to pay his deposit, or some portion thereof, to a named person, **the bank-note is a duly executed promise of the bank to pay to the holder of the note the sum of money specified thereon.** Professor Agger thus states the relationship between notes and cheques—

> " . . . The individual who acquires possession of a bank-note has, therefore, by virtue of his possession a right to demand money from the bank. But this is exactly the right conferred on the depositor by virtue of his 'deposit.' What, then, is the difference between the two rights ? The difference is only one of form and of scope of usefulness. The deposit is an unembodied right to demand money which circulates as a substitute for money in the form of a cheque requiring endorsement as it passes from hand to hand. The bank-note is an embodied right to demand made out to bearer, and hence does not require endorsement as it passes from one holder to another. But from the bank's point of view both of these forms of credit are 'demand liabilities,' i.e. liabilities which have to be paid on demand, and the necessity for keeping itself always in condition to meet 'demand liabilities' as they are presented is just as strong in the one case as in the other."

Experience and a knowledge of psychology have taught the banker that in practice he will never be called upon to redeem simultaneously all the rights of demand which are out in the form of deposit accounts and notes. But he may at any time have to redeem a larger proportion than the normal presentation of demands to reserve. There is no sound clue from day to day what may be the presentation of demands from hour to hour. True, in certain areas presentations may be broadly calculable. Agricultural bank users will present more demands at some seasons than at others. The probable demands of certain industrial and maritime communities can be estimated from trade or ship movements. Political menace or political tranquillity will affect the probable extent of demands. But income and outgo over the counter fluctuate and must fluctuate beyond the computation of the bank officers.

Adequacy of Reserve.

The bank does not exist primarily as a convenience for depositors. It exists primarily to make money for its shareholders. The greater the reserve kept by a bank, the smaller the scope for profit making. Timidity may incline a bank to large reserves, cupidity will incline it to a small reserve. Business sense will enable it to find the happy mean. That happy mean, however, does not lie between depositors and shareholders only. As an organizer of credit, the bank is a lender. Its capacity for arranging credits is governed in the last resort by the adequacy of its reserves. The demand upon it for credits is variable, and upon the response of the banks in general depends to a very large extent the welfare of the industrial communities. The history of banking is brightened by many examples of banks assisting the

communities they have served by placing in the background the interests of their own shareholders and tending first the social needs of the peoples about them. The cynic might argue that in such actions there was no altruism, since the bank survives only if the community survives, but, even so, what the cynic deducts for self-interest from the moral account of those so acting, he must add to it for courage and vision.

The calculation of a safe but not too large a reserve is aided by the knowledge that to the actual cash provided may be added investments of a nature to make them a secondary but quickly mobilizable reserve. The bank itself has assets. (I neglect, until we reach the section on company finance, the fact that the shareholders of a bank, like those of any other enterprise, are themselves its creditors. Any financial sophisticate reading this book will realize the implications of that fact, but the student need not at this moment be confused by it.) Of the bank's assets a proportion must be liquid, or of such a kind that they may without serious delay be easily liquidated. Nothing requires more care and shrewdness than the selection of a bank's own investments, but practice has evolved a rough category by which most banks are guided. Promises to pay cash, which liquidate themselves on maturity and which are backed by adequate security, are obviously the most desirable of all forms of investment. Of such promises, those given by traders with commodities either in transit or in process of manufacture are the best and most frequent. Loans which are secured by what is known as " stock exchange collateral "—i.e. loans against the repayment of which the borrower has deposited bonds or shares which can, if necessary, be sold on the stock markets—and loans secured by consumable commodities, for which a sale is always to be

found, are next in desirability. Loans secured by other commodities are also frequent.

Banker as Lender.

The banker does not anticipate having to realize on the security. He anticipates repayment by the borrower. None the less, his credit to the borrower can never be to the full extent of the estimated value of the security, for obvious reasons.

When, many pages back, I lent my pound to John Doe we saw how vital an element in the calculation of any lender is the period of time for which the loan is made. When we reach the study of the money market, we shall find the banks cognizant of this, and making loans on call—that is, loans which are repayable at the option of either lender or borrower—and short time loans.

From the viewpoint of the banker, therefore, the reserve must be high enough to prevent any awkward situation from arising in the event of an unexpected quantity of demands, but low enough to enable adequate profit to be made and adequate credit to be placed at the disposal of industry. In making advances, by which the banker fulfils his function *qua* lender, three considerations must govern the various transactions. The advances must be made with safety, the total of advances made must be kept within the desired proportion to the amount of liabilities already contracted, and they must be as liquid as possible. In addition to these factors, the advances must show a fair profit to the bank. Mr. F. E. Steele, in his admirable brochure *The Banker as a Lender*, lays down that not only must advances be profitable and a reasonable rate of interest charged, but that—

" . . . if the advance take the form of a loan, as distinct from an overdraft, an adequate current account balance (must)

> be maintained, and that if it take the form of an overdraft, a reasonable rate of commission (must) be charged on the turnover and that the turnover itself (must) be adequate."

This may, perhaps, be not unfairly summed up as an injunction that the banker must take care that he loses neither on the swings nor the roundabouts, which is a counsel of perfection, perfectly followed by most bankers.

Liquidity and Security.

It cannot be impressed too strongly upon those to whom banking is to become a profession that, paradoxical as it may read, liquidity is often of more importance than safety. Much safe security is offered day after day to the managers of banks and no advance is made, simply because the security is, in one sense, too safe. It is so safe, or rather so safeguarded, that its second transfer from the bank to a new purchaser, if that dire need arose, could not be effected quickly or easily. In the same way a too long standing overdraft may be perfectly safe, from a long view, but a nuisance to the bank which granted it. It may be taken as an axiom of banking that it is not the legitimate function of a bank to provide fixed capital for its customers. Fixed capital should be provided either by the entrepreneur himself, or by a partner brought in for the purpose, or, in the case of a company, by the shareholders, that is, the public. Advances made by a bank must be made with expectation of payment in a reasonable time. It is this truth which was summed up by a famous banker in an aphorism quoted, I think, by every writer on banking with approval, to the effect that " The art of banking consists in knowing the difference between a mortgage and a bill of exchange." The bill of exchange is an instrument with which we shall shortly become much more familiar. In Lord Sydenham's

dictum it represents short term advances as opposed to long term advances, the extreme form of which is usually the mortgage on property. Upon those who are making banking their means of livelihood I would also impress here—since I have for convenience not considered in this chapter a bank balance sheet—the warning that just as shareholders in any company are providers of capital which shows as a liability, so they are the ultimate owners of the reserve of a bank which, accordingly, is shown as a liability. A bank, like any other enterprise, is indebted to its shareholders for its capital. If it were "wound up," and were solvent, that capital would have to be repaid, and so, too, would the reserve have to be repaid. The bank as an entity is indebted to its depositors and to its shareholders, although the debts differ in their nature, and any debt is a liability. The realization of this fact is more than a point in book-keeping.

§ 4

In the organization of credit the banks, as we have now seen, attract and receive deposits, and transfer cash and credit. In other words, they make coincident the wants of the community, using in one place the accumulations of cash and credit gathered in another, enabling production to proceed before demand, and distribution to be set in motion at the needs of the producers as well as at the needs of the consumers. This they do by laying out the means of their depositors and shareholders in various ways, chief amongst them being by advances to persons who can make safe and profitable use of those means.

So far we have concerned ourselves chiefly with the performance of these functions by means of notes and cheques. We shall now glance quickly at other forms of **bankers' credits.** The **bill of exchange,** which deserves,

and has, a chapter to itself later, we have noticed in passing, and will now only superficially examine. I have supplied, let us say, Martin Jones with goods, for which he owes me money. I have bought from William Brown goods for which I owe him money. To William Brown I give a bill on Jones, which says "Three months after date pay William Brown so much money." Martin Jones is willing to honour my command (he accepts the bill), but Brown does not wish to wait three months. He takes his bill to the bank, which, knowing the parties concerned in the transactions, discounts it for him, i.e. the bank buys the right to call on Jones, for a sum a little less than the amount which Jones will pay and Brown could have had by waiting (see again page 67). In commercial practice the bill does not usually pass in this direct way, but, as we shall see later, a bill is drawn on a finance house of known reputation, one party to the transaction drawing on that house and the other providing it with security. A bank may either discount some other person's bill or may create a bill for some other person's use. In either event, by laying out its money for a short time it makes a fair profit and enjoys adequate security. If a bank is prepared to accept the bills drawn upon it by a customer, the process of giving the credit is simple. Hardly less simple is the manner in which a bank will reinforce, so to speak, the credit of a customer by its own, whether at home or abroad. This is done by the use of **letters of credit.**

Letters of Credit.

Story in his *Bills of Exchange* thus defines a letter of credit—

"A letter of credit is an open letter of request whereby one person (usually a merchant or a banker) requests some other

> person or persons to advance moneys, or give credit, to a third person named therein for a certain amount, and promises that he will repay the sum to the person advancing the same, or accept bills drawn upon himself, for the like amount. It is called *a general letter of credit* when it is addressed to all merchants or other persons in general, requesting such advances to a third person; it is called *a special letter of credit* when it is addressed to a particular person by name, requesting him to make such advances to a third person."

The most familiar letters of credit, perhaps, are those which banks issue to their customers who are about to travel. Such letters are as a rule requests from the issuing bank to its foreign agents to cash the drafts of the customer. The customer actually buys the letter of credit at his own bank—either by a cash payment or by having his current account debited with the amount—and is charged a small commission for the facility, usually about $\frac{1}{4}$ or $\frac{1}{2}$ per cent. In some cases the bank makes no charge, giving the facility free to a particularly good and influential customer. Such free issue is, however, not the fruits of altruism. There is behind it the expectation of profit on the exchanges and of some benefit from the accrued goodwill of the customer. In some cases the purchaser of the letter of credit is debited with the total amount of the credit, and in others only with the amount of outgoing from his account represented by his drafts upon it. The bank naturally prefers the first method, and for excellent reasons. The drafts which a customer draws upon his letter of credit must be met by the issuing bank. The bank or person making the payment can use the issuing bank in case of default, whereas if the depositor continues to draw after his funds at the issuing bank have been exhausted, the bank itself is left to face a loss. A letter of credit against which the customer's account is to be debited only for drafts drawn

is, thus, a dangerous instrument, and as such is issued only to persons or firms of the highest standing. A letter of credit debited as to its total when issued is free from defects, since the bank has in advance the funds wherewith to meet the obligations which it assumes on behalf of its customer.

A letter of credit is not a negotiable instrument. It cannot be used by an intermediary. With the letter of credit there is issued, as a rule, a letter of indication, which is in effect an identity certificate with a specimen signature. Since payment on a forged draft falls upon the payer and not upon the person whose name is forged, there is a self-protective obligation upon the banker or other correspondent to whom a letter of credit is addressed to demand the production of the letter of indication. Legal rulings and a full examination of the usage of such letters will be found in Mr. William F. Spalding's book on *Bankers' Credits*, which covers in some detail an aspect of banking which here can be only very superficially surveyed.

Opening a Credit.

In addition to letters of credit the banks can mobilize and make coincident the credit and wants of producers and traders by the process of "opening a credit." Of the use and need of opened credits we shall become acquainted when we look at the foreign exchanges. It amounts in effect to an authorization by a purchaser in one place to a vendor in another place to draw upon a certain bank, which, acting upon instructions, will accept the bills drawn upon it to the limit of the credit which has been opened. The vendor does not receive in such case a letter of credit, but receives an intimation from the bank in his own place that it is instructed to negotiate

his bills drawn on the purchaser's bank in the other place.

A banker's credit may be "confirmed" or "unconfirmed," and if the latter, i.e. the intimation from one bank to another that a credit has been opened, it is merely an advice, and can be cancelled. A confirmed credit is one in which the bank itself guarantees to the drawer of the bills that any drafts drawn shall be duly honoured. It is not one which has merely been confirmed in the loose clerical sense that the first advice of its having been opened has been followed by some more definite form of intimation. A confirmed credit is not opened until the issuing bank has obtained a firm guarantee from the person who has it opened that he and his assets will indemnify the bank against any loss arising from the bank's acceptance of bills drawn upon it.

Traders and members of the money market are familiar with many variations of bankers' credits, but the principle behind them all is the same.

It will be seen that the banks, in permitting the use of any of their instruments, whether the cheque or the letter of credit or some other, may have from the customer either a solid deposit or security for credit only. Let us consider for a moment a simple transaction.

I buy from you the Baby Austin which you are discarding in favour of a Lanchester, following your recent stroke of luck in winning the Calcutta Sweepstake. Not having at the moment when we make the bargain sufficient funds from which to pay you, I promise you your money in three weeks. I may either give you some form of promise to pay on the agreed date, or I may give you a cheque bearing that date at its head. Let us suppose I give you the post-dated cheque. On the day before it is ready for presentation to my bank I may

either deposit there a sum sufficient to cover it, or I may persuade the kindly manager to allow me to overdraw my account to that amount. If I make a deposit the bank enters to my credit the sum I pay in, and when you present my cheque enters to my debit a similar sum, thus beginning the process of transferred credit which we examined a little while ago. If I ask for an overdraft and secure it, the same process takes place, but the bank has transferred not my credit but its own, in the expectation that I will in due course replace that which has been transferred and with the knowledge that for the use of the bank's credit I will pay to the bank some small extra sum, generally 1 per cent over bank rate. (Stated briefly, an account at a bank may consist of something paid in which is to be drawn upon, or of an advance made by the bank which is to be drawn upon.)

Obligation on the Bank.

In the first place my relationship to the bank is changed by the circumstance of my drawing the cheque upon an account which I created by my deposits, as against the circumstance of my drawing the cheque upon an account created by the bank's making me an advance. If my money is with the bank, the bank is my debtor. If the bank has advanced me the equivalent of money, I am a debtor to the bank. There is a legal obligation upon my banker to pay my cheques while I have an account with him, but whether he will grant to me a right to an overdraft depends entirely upon his goodwill and his confidence in me. It is a matter of arrangement. If he does grant an overdraft, and enables me to pay you for your Baby Austin although I have no money of my own, what has he done? Has he manufactured credit or has he merely mobilized it?

Despite much talk, and more superstition, about the power of the banks to manufacture credit, they possess no such magic. The most they can do is to mobilize credit which already exists. The effect may be, and is, almost precisely the same, but the limitation to the banks' activities is greater when there is no power to manufacture. The overdraft which I am permitted to draw upon, if we think about it for a moment, is not created by the bank. All that the bank has done is to enable me to avoid an awkward series of bargains. I might have given you for your car a certain amount of my labour, or the right to draw the pay I would receive some weeks after for labour given to somebody else. I might have given you a valuable first edition of one of Barnaby Brook's novels and when I had sufficient funds asked you to sell it back to me. I might have let one of my rooms to a lodger and instructed him to pay his first month's rent to you instead of to me. I might, in short, have done any one of a series of transactions. But the bank by mobilizing my credit made coincident my want to purchase your car and my power to do so with your want to dispose of it.

"Manufactured" Credit.

Reformers of society often rail at the banks because they will not "manufacture" more credit when more credit is needed. The charge is that when credit is not mobile enough, the banks are slow to mobilize it to the fullest extent of the supposed needs of society. But any student of the financial system or of the banking system, before supporting such a charge, must remember that, as I have said, the responsibility of the bank is not to the community, but to the shareholders. A private banker might, since he adventured only his own fortunes, grant credits to any limit he cared to fix. But those

responsible for the conduct of the business of shareholders cannot adventure funds for which they carry responsibility beyond a certain safety margin. Nor could a State bank, responsible for the taxpayers' money, exceed some such limit. It must also be considered whether a banker who extended credits because of a feeling that the community needed more media of exchange, and who eventually involved his bank in ruin because he had miscalculated the position of the safety margin beyond which credits could not be mobilized, would not in the ultimate event cause more hardship by his collapse than he prevented by his readiness to grant credits widely. This is not the place in which to embark upon a thorough examination of such problems, but the student who hopes to master all the ramifications of finance and to grasp the reasons behind the conduct of those to whom finance is a business, must not lose sight of the fact that those who handle money and organize credit are subject to limitations of action which are not always apparent to the superficial observer, and that altruism to the public at large may often be treachery to a particular section of the public.

§ 5

No survey, however brief, of the banks and their functions would be complete without some examination of Central Banking. Since I propose to postpone a study of the Bank of England, our native example of a Central Bank, until we examine the Money Market and National Finances, I will conclude this chapter by a sketchy, but as I hope, adequate, outline only of Central Banking.

In looking at the development of money and the rise of currency systems, we saw that the need for currency varies from time to time in relation to the varying

quantities of goods and services to be exchanged. We saw, too, that when there was a stringency of official money the community was prepared to take promises to pay and use them as an unofficial currency, which meant that credit was organized and used to supply the gap between the need for and the supply of currency. But credit-currency was not always a perfect medium. When the community was subject to some passing passion for speculation, those who controlled and created such credit currency were tempted to increase it beyond the just mobilization of credit. They tried, in effect, to create credit where none economically existed. Bank-notes were issued in excess of the legitimate trade need for them, with the result that goods were imported on the supposition that, as there was plenty of " money " available, there would be a ready sale and consumption. But the foreign manufacturers and distributors would not accept, naturally enough, the bank-notes of banks of which they had no personal knowledge. They demanded gold, and gold went out of the country.

A Run on the Banks.

Now we saw that, although in practice the community rarely asks for credit instruments to be redeemed, there is always liable to come a time when the public realizes that there is only a small quantity of the actual and tangible wealth which paper represents to satisfy a large number of promises to provide it on demand. A man does not really want gold, but he feels that he may want it, and if the banks have little of it, since much of it has left the country, he also feels that the banks will act on the age-old principle of " first come, first served." Everybody sharing these feelings tries to be first in the demand for gold, and there is a run on the banks.

That was the experience in the older times. The banker who had counted upon a continuance of the conditions under which few of his notes were presented for redemption kept little reserve. He kept only sufficient coin in hand to cover a "reasonable" proportion of his liabilities. What happened? In the words of the late Dr. Leaf, such a banker, in such circumstances as we are examining,

> ". . . suddenly finds that no one is 'reasonable'; panic is universal, and his reserves are being rapidly exhausted. He sends off post-haste to his correspondent in the capital, and requests an immediate loan in coin, for which he can deposit undoubted security. The correspondent replies that he does not doubt the security, but that he can with difficulty get enough coin to supply his own needs, and can certainly not find any for the country, as the stock of gold in the Bank is getting dangerously low. The result is that the country banker, though he may be in the long run perfectly solvent, has to announce that he is unable to meet his notes in coin—he 'suspends payment.' The further result is that his customers who hold his notes are reduced to desperation, and immediate and perhaps final, poverty. This is the tragedy which has been played over and over again, not only in England, but in every country which has reached a certain point of economic development. The circle of events seems so certain and its culmination so disastrous, that every country has been forced to take steps to control it. The problem everywhere has been the same —to obtain the benefits of a 'fiduciary' currency, i.e. a currency based upon the credit of the issuer, while avoiding its great danger . . . . When Governments, therefore, set themselves seriously to retain the advantages of a paper currency, while controlling the evils of undue inflation arising from an excessive issue of paper money, or undue extension of credit in other directions, they have turned to the institution of some central body which could be entrusted with the task of watching the general stock of gold, and empowered to take steps to repress any undue expansion of credit, while holding power to increase the supply of currency when the legitimate demands of trade require it."

With the selection of a central body to be so entrusted there was an obvious need to prohibit the issue of currency

by other bodies, as was done in our own history during the days described in the last chapter of this book.

A Central Bank, then, watches the stock of gold, represses undue credit expansions, and inaugurates expansions which are deemed desirable. In addition to these primary functions, it usually carries the Government account, issues public loans, and acts as the banks' bank. We shall see how the Bank of England performs these functions at a later stage of our inquiry.

Bank for International Settlements.

On the 13th of November, 1929, there was signed at Baden-Baden the draft Charter and Statutes of the Bank and Trust Agreement relating to reparations. In other words, there was created a central bank for central banks, to be known as the Bank for International Settlements. A discussion of the history of reparation payments is outside the scope of this book, but thoroughly to appreciate the place which the new bank will play in international life one must study the Dawes Report (more accurately known as the Experts' Report) of 1924, the workings of the Dawes Plan, and its supersession by the Young Plan. Of the Young Plan the proposals for such a bank occupied a large part, although they were there left vague. The new bank was conceived as having three functions, the limited and formal work of receiving and transmitting reparation payments, the securing to Germany of some measure of transfer protection, and the work of acting, as I have said, as a central bank for central banks.

The task of formulating a definite constitution for the Bank was given to an organization committee, whose report embodying that constitution is to be subject to the approval of the affected governments. In the draft

statutes the committee makes ample provision for what may—and should—become the most important work of the new bank, the third function mentioned above. If it is properly applied, the Bank for International Settlements should become an organization for international co-operation in the creation and regulation of credit and the direction of capital, no less than for the business of conducting international payments.

The " B.I.S. "—to give it its already accepted colloquial name—may have its registered office at Basle. Its official objects are " to promote the co-operation of central banks and to provide additional facilities for international operations, and to act as trustee or agent in regard to international financial settlements entrusted to it under agreements with the parties concerned." Its operations have to be in conformity with the monetary policy of the central banks of the countries concerned, and before any financial operation is carried out by or on behalf of the Bank on a given market or in a given currency, the board must afford to the central bank or central banks directly concerned an opportunity to dissent. Dissent will in such cases amount to a practical veto.

Its Operations.

The operations of the B.I.S. on its own account are only to be carried out in currencies which, in the opinion of the board, satisfy the practical requirements of the gold or gold exchange standard. The nature of the operations to be undertaken by the Bank is determined by the Board of Directors. These operations are mainly concerned with the buying and selling of gold coin and bullion, the holding of gold, making advances to the central banks or obtaining advances from them on gold, bills of exchange, or other first-class security; the discounting or

re-discounting, and the buying and selling of foreign exchange. The International Bank may act as agent or correspondent of a central bank and may appoint any central bank to act as its agent or correspondent. If the establishment of a branch of its own is considered advisable, the approval of two-thirds of the board is necessary. The International Bank may enter into special agreements with the central banks in order to facilitate the international movement of funds.

The following transactions are expressly prohibited: To issue bank-notes payable to bearer at sight, to accept bills, to grant loans to governments, to open current accounts for governments, to acquire controlling interests in an undertaking, to retain property not required for purposes of the Bank's own business longer than is necessary to dispose of it advantageously, should the Bank have taken it over as cover for liabilities of third parties.

Administration.

The administration of the Bank is in the hands of a board of directors, and has at its head a " Director-General—i.e. a general manager, not, in the English sense a " director "—who is responsible for management to the president. Of the board the heads of the central banks of the seven guaranteeing countries are ex officio members. Each, according to the draft statutes, shall appoint a substitute, and also a representative of finance, industry, or commerce in his own country. During the period of the German annuities the Governor of the Banque de France and the President of the Reichsbank may each nominate an additional director for commerce. In addition to these, fourteen or sixteen directors shall be selected, at least nine more from lists of four candidates presented by each of the heads of the central banks in countries other than the

seven mentioned above, which participate in the share ownership of the International Bank. Members of a Government, State officials, or members of a legislative body are not eligible for directorship unless they happen to be heads of a central bank.

Capital and Profits.

The capital of the Bank is 500,000,000 Swiss francs—determined precisely at 145,161,290 grammes fine gold—represented by 200,000 equal shares. The capital is guaranteed equally by the Bank of England, the Banque de France, the Reichsbank, the Banca d'Italia, an unnamed private bank on behalf of the Bank of Japan, and an unnamed American bank. When 112,000 shares have been issued the Bank may start business. The remaining 44 or less per cent may be offered in the course of two years to central or other banks which have not participated in the first issue, but only in countries interested in reparations or whose currency, in the opinion of the board of directors, fulfils the practical requirements of the gold or gold exchange standard. Any shares remaining unissued at the end of two years must be taken up or disposed of by the guaranteeing banks.

Twenty-five per cent of the value of the shares will be paid in on issue; the rest may be called up at the discretion of the Bank in one or more instalments at three months' notice. The capital of the Bank can only be changed on a proposal of the board passed by a two-thirds majority and approved with the same majority by the general meeting.

The possession of shares, which will be registered, does not carry with it the right either to vote or to take part in the general meeting; only the central banks have the right.

The yearly net profits of the Bank have to be applied as follows—

(*a*) Five per cent thereof to a Legal Reserve Fund, till that fund amounts to one-tenth of the paid-up capital.

(*b*) A cumulative dividend of 6 per cent on the paid-up capital.

(*c*) One-fifth of the remainder to the shareholders until a maximum further non-cumulative dividend of 6 per cent is reached.

(*d*) One-half of the balance to a General Reserve Fund until it equals the paid-up capital, and thereafter, on a decreasing scale, until 5 per cent of the balance is paid when the fund is five times the paid-up capital.

(*e*) During the currency of the Young Plan the remainder of the net profits is distributed as to 75 per cent to the reparation countries in proportion to the long-term deposits maintained by them with the Bank, and as to the remainder to a special fund for aiding Germany in paying the last twenty-two Young annuities, on condition that she makes a special long-term deposit of 400,000,000 Reichsmarks; if she elects to deposit less, her participation in this 25 per cent remainder will be proportionately reduced, the difference being added to the share of the long-term depositors previously mentioned. If the 25 per cent more than covers the last twenty-two annuities, the balance goes to the creditor governments in proportion to their net debt payments. The Special Fund constituted under this provision earns compound interest at the maximum current rate paid by the Bank on time deposits. At the end of the Young Plan period the disposal of the last 25 per cent above shall be determined by the general meeting, on the proposal of the board.

An Interesting Experiment.

As the second edition of this book goes to press the B.I.S. can only be described as an interesting experiment, but an experiment fraught with very far-reaching consequences either in its success or its failure. The new bank has to exercise its functions without antagonizing the interests of national banking systems, whose freedom of co-operation is very wide. In a way, the position of the

B.I.S. *vis-à-vis* national banking systems is that of the League of Nations *vis-à-vis* national governments. Only if the chief central banks give to it a full measure of co-operative support will it be able to prove its worth. It is they who can make it the new organ for organizing and co-ordinating world credit which I have envisaged, or who can confine its functions to those of a mere clearing house for international payments and an international warehouse for gold stocks. The fulfilment of the larger function implies the command of the Bank over large resources and its power to grant or withhold large-scale credits. This command and this power it does not intrinsically possess, but may attain.

In America.

In America the history of banking has been very different from our own. Prior to 1914 the uncontrolled activities of American bankers had brought the system to the level of a byword for inefficiency and ineptitude, the decadence culminating in the crisis of 1907 and lingering for another seven years, while reform was debated by financiers, politicians, newspaper writers, and the corner-boys of the then existent saloons. In 1914 Congress passed the "Federal Reserve Act." In studying the American system it is necessary to remember the force of the political convictions behind the Act of 1914. State rights are very real to the American, and a Bank of the United States could never achieve the position held in Great Britain by the Bank of England.

The United States, under the Act, are divided into twelve districts, each with a Federal Reserve Bank of its own. The twelve banks are collated and their co-operation ensured by a Federal Reserve Board which sits at Washington and exercises considerable powers

over each of the twelve. The twelve Federal Reserve Banks have each "member banks." All national banks must become members, and State banks are encouraged to do so.

The member banks subscribe capital in proportion to their own capital and can claim a dividend of not more than 6 per cent, further profits going to the Treasury of the United States. The member banks appoint three directors representing their interests, and three more to represent the local business interests of the area. Three other directors are appointed by the Federal Reserve Board, one of whom is chairman, and thus becomes "Federal Reserve Agent."

Each Federal Reserve Bank is sanctioned to use notes, which are obligations of the United States and are receivable in payment of all taxes and public dues, but which are not legal tender. These are Federal Reserve notes, and any Federal Reserve bank may apply for them against collateral security of "notes, drafts, bills of exchange, bankers' acceptances or gold or gold certificates," but is required to "maintain reserves of gold or lawful money of not less than 40 per cent against its Federal Reserve notes in actual circulation." In addition to Federal Reserve notes, there is provision for Federal Reserve bank-notes. These are issued and redeemed as if they were national bank-notes, but are the obligation of the bank, and are subject to special regulation. It is the Federal Reserve note which is the permanent and elastic currency produced by the system, and these circulate in denominations of $5, $10, $20, $50, and $100, the fact that they are not legal tender not impairing their general acceptability.

In Germany the Reichsbank has the right of note issue for fifty years from the London Conference which

modified the Dawes Scheme, but the existing rights of certain smaller banks are reserved. As, however, the banks of Wurtemberg, Bavaria, Saxony and Baden do not issue together more than 194,000,000 marks, this reservation does not affect the Central Bank functions of the Reichsbank.

§ 6

In addition to organizing credit in the various ways we have just examined, the banker performs many other functions, some of which are not, strictly speaking, within the purview of a work on finance. He will, for example, take into safe custody the valuables of his customers, just as the original goldsmiths did, without any question of an advance on them being involved. In such a case the banker is acting as **a bailee**, and his relationship to the customer is no longer that of debtor and creditor. He may act also as sole executor under a will or as trustee under a will or settlement or as custodian trustee. In his dealings with his customers a banker is in something like the position of a doctor with his patients, he is under a well understood pledge of secrecy, but may be compelled by law to disclose his customers' affairs. This obligation of secrecy extends after the closing of an account. A bank may, in addition to the debtor-creditor relationship, create between itself and its customer the relationship of agent and principal.

For the convenience of the student of banking, as such, I will set out the occasions on which the secrecy of the banker may be broken: (*a*) Under an order according to the Bankers' Books Evidence Act; (*b*) when public duty, such as the safety of the State, is held to override the duty of an agent to his principal; (*c*) where for the purpose of recovering its own debt from a customer

the bank issues a writ stating the amount owed; and (*d*) at the request or with the consent of the customer, as where a trader or citizen gives his bank as a reference. Banks exchange opinions as to the standing of customers, but such opinions must be requested and granted with the greatest discretion. Mr. William Thomson, in his *Dictionary of Banking*, reviews concisely the law with regard to such opinions, and to that work the student is recommended.

[The ground covered in the first six chapters of this book is a starting point for each of the sections which follow. The arrangement of later chapters has necessarily had to be arbitrary. There is no reason why the reader primarily interested in company finance should take the foreign exchanges or the money market first. He may now turn immediately to the chapters which interest him.]

CHAPTER VII

THE FOREIGN EXCHANGES

In studying the development of trade and money we have seen that one of the first complications in human relationships arises when members of one community begin to have dealings and economic intercourse with members of another community. An exchange of crude forms of wealth between members of different societies can never have presented much difficulty, save as to the fixation of its value, but once money was created—even while it was still uncoined money—other difficulties arose. The exchange of credit between persons who knew nothing of each other's stability, solvency, or integrity would, even in the simplest communities, become a difficult transaction to effect. In complex and congested communities, personal and individual exchanges have eventually to be systematized, and create, as we know, specialists whose business it is to facilitate such transactions. When we reach a stage of world civilization in which individual members of different complex and congested communities are exchanging goods, the need for such specialists is even more acute.

John Jones of Upper Thames Street, London, will sell goods to William Brown of Queen Victoria Street, London—a distance of a few yards only—and will accept in exchange the current coin of the realm, or notes, or a cheque, or a bill of exchange, or even a verbal promise to pay at some given date. John Jones of Cardiff, will sell goods to William Brown of London, and will accept current coin, note, or perhaps a bill of exchange or a

cheque, or even a verbal promise to pay, if he has some knowledge of William Brown. But Jean Jacques of Paris, can hardly be expected to sell goods to William Brown of London, unless William Brown will send him goods, or gold, or something which is intrinsically valuable to the recipient. William Brown's current English coin may be debased or inflated; the notes may seem to Jean Jacques to be worthless paper.

Organized Exchanges of Goods.

But if Jean Jacques and William Brown only exchange goods for goods, or goods for gold, they are really back at a primitive condition of barter. Not only would all traffic be delayed, but the tremendous difficulty of making wants coincident and finding means of moving bulk commodities amongst persons changing them to meet the needs of barter would be almost insurmountable. The merchants of Amsterdam, at whose experience we glanced two chapters back, were by the difficulties of trading with persons outside their own State, driven to the creation of central banking, but even central banking alone did not solve the problem of how most easily and most cheaply to organize the exchanges of goods and services between the nationals of different States.

Whether trade is being conducted between neighbours in the same community or between strangers separated by vast distance and differences of habit and custom in the last resort, goods and services must pay for goods and services. The use of money or of credit is only a means of facilitating this process. In national trade two factors are involved. There is the exchange of goods or services between each individual citizen and his fellows, and there is the exchange of goods or services between

the nations of which the individual exchangers are but units. In the conduct of my own economic life I know that, broadly speaking, the services and commodities which I obtain from the community must be paid for by the services and commodities which I render to the community. (This is not affected by any false moral or social values which may happen to be placed on either goods or services on either side of my transactions. I may, it is true, only render to the community the service of being a very decorative member of society bearing my father's name, and you may think that service too highly valued. I may, on the other hand, render to the community the inestimable service of producing some of its essential commodities or providing the communal life with beautiful adornments or spiritual aspirations, and I may think that service too lightly valued. The principle enunciated above, I repeat, is not affected.) In the conduct of the life of a nation the same principle applies. As Professor Marshall has expressed it—

> " . . . The direct gain which a country derives from her foreign trade consists in the excess of the value to her of the things which she imports over the value to her of the things which she could have made for herself with the capital and labour devoted to producing the things which she exported in exchange for them: the costs of working the trade being, of course, reckoned in."

The briefest expression of this fact is the familiar axiom, " Exports pay for Imports," which must be construed as including not only exports and imports of goods but also of services.

Striking a Balance.

If I, as an individual unit of society, regulate my purchases by my income over a long period of time, it will be true to say that my exchanges of goods or services

will balance. I may, however, buy more things than I can pay for, in which awkward event I become bankrupt. Almost inevitably there will be times when, if I were forced to strike a balance, I should have either more liabilities than assets or more assets than liabilities. So it is with nations.

Let it be conceived for a moment that I live by making that popular commodity, the invisible paint for dotting double-blank dominoes. The complexities of our communal life have created a steady and even huge demand for my product. The centralization of industry has caused many hundreds of young men to congregate each day in a congested area for the purposes of their own means of livelihood. Their constant presence there has prompted enterprising gentlemen to provide tea shops and restaurants in the neighbourhood. The need for mental relaxation, and the realization that a change of occupation is the best rest, has inspired many of these young men to take to the vice of domino playing for an hour or so each morning. My special paint is, therefore, in great demand, and I am one link in a chain of economic cause and effect which joins us all together. For some reason or another I am compelled to adjust my accounts with society. I find that I have received rather more goods and services than I have provided. I therefore sell more of my invisible paint to the domino dotters. But the domino dotters may not be prepared to take more paint at that moment. I must then satisfy the adverse balance of my accounts with society by parting with some of my other acceptable assets. I must sell my car, or my collection of old masters. Again, so it is with nations. But a nation rarely sells its old masters—although Russia has recently (1928) marketed the old masters of some of its expropriated citizens—or its general assets—

although sales of territory have not been unknown to history. When national imports exceed exports, the balance is settled by a transfer of gold. Gold, as we know, is generally acceptable all the world over.

It would be folly if every individual trader contemplated sending gold to his creditors abroad. We have seen earlier in the book that a transaction between persons of different nations may be described in each case as a double transaction, a man buying goods abroad and then buying the currency wherewith to pay for them. In practice, a transaction does not present itself that way to the purchaser concerned. If I import goods from France I can pay in a variety of ways. I can, but rarely do, buy the currency of that country and remit it to my creditor. I can accept a bill of exchange drawn upon me by my creditor. I can buy for cash in my own town a bill drawn on someone in France and payable there, which bill I can post to my creditor. Or I can actually send bullion.

Concurrent Transactions.

But, while my transaction with the vendor of goods in France has been proceeding, other transactions in which we are both involved may also have been proceeding. Most certainly there will have been concurrent transactions between other Frenchmen and other Englishmen, between Frenchmen and Americans, Englishmen and Americans, Frenchmen and Germans, Englishmen and Germans, Germans and Italians, Italians and Frenchmen, Italians and Englishmen, and so on. If all these transactions were settled by exchanges of gold it would happen that at any given period England might have a right to gold from France but be under an obligation to send gold to Germany, who might be owing gold

to France or America, and again through a complicated series of indebtedness the relationships would be entangled.

In practice, however, little gold passes, because we all prefer to use bills of exchange, since, unlike gold, these bills are neither expensive nor awkward to remit nor expensive to insure.

I draw a bill on my creditor, John Doe, who accepts it. In three months I will get my money, if I wait. But I need money now. I take the bill to a bank or a bill broker and sell it to him. He discounts it for me, but he does not retain it. In his turn he sells it to some foreigner who wishes to pay a debt in this country. Now when we said that England has a right to gold from France, we meant that France had bought more from England than England had bought from France. When we said that Germany owed gold to France, we meant that Germany had bought more from France than France had bought from Germany. There are Frenchmen in France with greater debts to pay in England than Englishmen have to pay in France, and there are Germans in Germany with greater debts to pay in France than Frenchmen have to pay in Germany. What happens ?

At Premium or Discount.

Frenchmen want more bills on London than are available. He who buys a bill is saved the trouble of shipping gold. When demand exceeds supply, prices go up. The price of bills in Paris rises. We say that bills are **at a premium.** The reverse is the case in London. There are more bills available than are in demand to pay English debts in France. Bills are **at a discount.** But, in some country, Frenchmen will find bills at a discount because that country has bought more from

England than she has sold. If this condition pertains in Rome, the Frenchman instead of buying bills in Paris, where bills are at a premium, can (in theory) buy them in Rome, where they are at a discount. (In actual practice it is the arbitrage dealers who alone glean a profit on slight differences in equivalent rates.) We shall see in a little while that there is an obvious limit to the rise or fall in the value of bills, but for the moment I merely wish to make clear the extra complication which arises in international trade from the fact that the very means of facilitating exchanges of commodities become themselves commodities.

We thus have a state of affairs in which nations, through their citizens, are trafficking in goods and services and trafficking also in the means of exchanging those goods and services. When it is realized that owing partly to the paucity of our vocabulary, and partly to carelessness of the users of our vocabulary, the same term is used by different people at different times to refer to one traffic or the other, it will be plain why to the neophyte the foreign exchanges seem something like the Mad Hatter's tea party, and something like "an awful voice dictating an interminable sum, changing to a tangled story—'What she said you said I said . . .'" The confusion is more apparent than real, despite the extreme complication of the machinery employed to effect transactions themselves extremely complicated.

§ 2

He who seeks for a definition of the term "Foreign Exchanges" will find his need met by the opening lines of George Clare's celebrated little book *The A.B.C. of the Foreign Exchanges* (Clare and Crump).

"Like many other of the cumbrous and archaic pieces of

jargon that enter into the language of commerce, the term 'Foreign Exchanges,' taken by itself, is so vague as to convey scarcely any definite image to the mind of those to whom use has not rendered it familiar. In expositions of the theory, it is usually described as an explanation of the means by which the mutual indebtedness of nations is paid off and cancelled, or, in a narrower sense, of the principles on which foreign bills of exchange are created and dealt in, and on which their price is fixed; but in actual practice we almost invariably find it employed with the significance of rates of exchange. In America the ambiguity goes even further, 'exchange' there being an expression that commonly passes current for 'bills of exchange.' The same phrase is used loosely in England."

Another attempt to meet the need for a precise definition gives us—

"Under the designation 'Foreign Exchanges' are included all those transactions which have for their object the transmission of capital from one country to another. In other words, the Foreign Exchanges are concerned with the buying and selling of the money of other countries, and the rates at which the money of one country may be exchanged into that of another country." (*Thomson's Dictionary*.)

Goschen, in his classic *The Theory of the Foreign Exchanges*, had noted the ambiguity of the term, stamping the phrase as "in itself vague, being more frequently used to express the rates at which the exchanges in question are effected than the exchanges themselves—the prices rather than the transactions." He endeavoured to dispense with a precise definition by supplying a concise account of the operation.

". . . As the result of international commerce, a certain portion of the community has become indebted to merchants in foreign countries; and in order to save the trouble, risk, and expense of sending coin, it seeks out another portion of the community to whom a similar amount is owing by the identical foreign countries in question, and, buying up those debts, assigns them over in payment to its own foreign creditors. And if the aggregate sums owing by the two countries to each other were absolutely equal—that is to say, equal in amount, coincident as to the period fixed for settlement, and

payable, too, in an equal or identical currency—there would be no difficulty of any kind in determining the equivalent which the purchasers of such claims would pay to the sellers. It would simply be a sum equal to, or rather identical with, that which is payable abroad under the transferred claims. The amount required by the purchasers being equal to the amount held by the sellers, and required, too, at the same time, there would be no cause in operation to vary the price, and there would be no fluctuations in the rates of the Foreign Exchanges. In technical language they would always remain at par. But, conversely, we arrive at the point which forms the essence of the present discussion : the fluctuations which actually take place in the Foreign Exchanges are at once the necessary result and the certain index of the inequalities which exist in the indebtedness of different countries, inequalities either in the amount of their liabilities or in the time within which payment must be made or in the relation of the currency of one country to that of another."

Having emphasized the ambiguity of the term I commend to the student two recent definitions either of which is adequate to its purpose. Mr. Hubert C. Walter, in his *Modern Foreign Exchange*, describes foreign exchange as—

". . . the business of exchanging currencies, or as the study of the ways in which currencies are exchanged ; the Foreign Exchanges are the markets in which this business is done ; and the Rates of Exchange are the prices of the various national currencies in terms of other national currencies."

Mr. H. F. R. Miller in his *The Foreign Exchange Market*, cautiously elaborates a little the last part of Mr. Walter's definition. Mr. Miller says—

" We may define Foreign Exchange as that branch of finance whereby the citizens of one country can acquire the means of making payments to the inhabitants of other countries, and the term is usually confined to those payments which are effected by means of credit instruments, and not by the actual transmission of gold. The Rate of Exchange is not the price paid to obtain the actual legal tender currency of one country, though actual notes and coin are often bought and sold in small quantities. But it may be defined as the price at which command over a certain amount of money in one country can be acquired in terms of the monetary unit of another country."

The essential point in all these attempts at definition, and confessions that precise definition is not possible out of a context, is that which I have endeavoured to make earlier in this chapter, that foreign exchange, and the foreign exchanges, involve two separate traffics, one in goods and services and the other in the means of exchanging those goods and services. If that point is kept clear in the mind the motives behind the various transactions which we shall examine will emerge and make plain much that would otherwise be obscure. To adapt Goschen, the fluctuations of foreign exchanges must always be seen as the reflex of the fluctuations in foreign trade, even though at times it will seem that the fluctuations of trade are the reflex of the fluctuations of the exchanges.

CHAPTER VIII

THE FOREIGN EXCHANGES (CONTD.)

GOSCHEN'S theory of the foreign exchanges remains the classical exposition of what is supposed to happen in the international trading life of the nations. I must confess that my own study and experience have not led me to doubt the soundness of his analysis, nor has the history of the war and post-war years shaken to any extent the theoretic structure which he raised. The fluctuations of the exchanges to him expressed the state of international indebtedness after allowance had been made for such factors as time, distance, interest, and currency depreciation.

But stated so simply the theory cannot, we must admit, satisfy the ordinarily observant inquirer. Indebtedness is itself a vague term. Since, as we agree, all exchanges come in the last resort to exchanges of goods and services, and since, as we have seen more than once in observing such exchanges, the relative value of goods to goods and services to services may itself change, is it possible to indicate by the fluctuations of "the exchanges" an indebtedness which is itself liable to fluctuations? Let us suppose that £1 in England buys a pig, and a "nodup"—the standard coin—in Erewhon, also buys a pig; £10 will equal ten "nodups" or ten pigs. Ten "nodups" will equal £10 or ten pigs. If after the balance of trade between England and Erewhon has been struck Erewhon still owes ten pigs to England, but has no pigs, it can exchange ten "nodups" for £10 and remit that sum to the English creditors, and all will

be well. But if, owing to internal price fluctuations, £10 in England no longer equal the value of ten pigs, all will not be well, or if, owing to price fluctuations in Erewhon, pigs are selling at less than £1 each, the £10 remitted will represent to the Erewhonians a greater payment than was really to be made. International transactions in real life, we know, are nothing like this mythical exchange, but the example will demonstrate the uncertainty of values as measured by currency exchange values. If in England £10 will no longer buy ten pigs, the English will say that the price of pigs has gone up, but the Erewhonian will say that in England the value of the £1 has fallen. These are two ways of stating the same fact. The price of pigs may have risen in England because pigs are scarce.

The Quantity Theory.

Those who believe in what is known as "**the Quantity Theory of Money**" will say that the price of pigs may have risen because pounds are plentiful. Pounds may be plentiful either because other commodities, which people exchange for pounds, are plentiful, or pounds may be plentiful merely because more pounds have been issued. The quantity theory of money holds that if a supply of commodities offered for sale is unaltered, and the rate of money circulation does not increase or decrease, then the level of prices will rise or fall in proportion to the amount of money in circulation. But it is quite obvious that, by the pig buying standard, if a pig costs a "nodup" in Erewhon and costs £1 and a fraction in England, a "nodup" no longer equals £1 in the exchanges between the two countries. If both the £1 and the "nodup" contain 123¼ grains of standard gold, each should equal the other. What, then, has happened when both continue

to contain 123¼ grains of standard gold, but one coin buys a pig in one country whereas the other coin will not buy a pig in the other country?

It is evident that two currencies equal in value by the test of their gold content may or may not be equal in value by the test of their purchasing power.

From the realization of this fact we have had recently a new theory of the exchanges, called "the purchasing power parity theory." I will state it in the words of one of its most severe critics, Dr. William Shaw, who, in his *Currency, Credit, and the Exchanges*, says of it that it is in reality—

> ". . . an attempt to present the classical theory in a more fantastic and striking garb. For it is admitted that currency depreciation in the case of paper money, or currency debasement in the case of metallic money, or the lowering of the monetary standard in the case of both, finds instant expression in the range of domestic prices as compared with prices in gold standard countries. On the assumption that the extent of the rise of internal or domestic prices is the measure of the depreciation of the currency, then (so runs the statement of this new theory) the purchasing power of the domestic currency will stand to the purchasing power of a gold standard country in the ratio of the internal domestic price range of the one against the international price range of the other, and this ratio of purchasing power will be, or will tend to be, the ratio or rate of exchange between the two countries or the two currencies."

Dr. Shaw finds the same objection both to the classic theory as enunciated by Goschen and the new "purchasing power parity theory." It is that both confuse a marginal with a totality effect.

Conflicting Views.

Goschen taught that an adverse trade balance will cause an adverse exchange. An adverse rate of exchange will cause bullion to be shipped. Bullion being shipped,

the currency will contract. As currency contracts prices fall, for reasons that we have already studied. A fall in prices means a recovery of trade, which means a recovery in exchange, and so the position rights itself, by cycles. Dr. Shaw maintains that the ebb and flow of trade balances have cycles of their own much slower in process than the classic theory demands. He says, forcibly enough, that "anyone who has an inside knowledge of exchange banking, and who is acquainted with the process by which every morning the exchange rate is born or made, knows how really unrelated to trade balances the exchange quotations are." This means, as I understand it, that the specialists who traffic in the means of foreign exchanges of commodities do not fix their own prices in any conscious relation with the prices of the other commodities, the exchange of which they are supposed to be facilitating. This, I think, is true enough. But the relation is none the less there, and the student of finance, not yet acquainted with its practice in the foreign exchange market, will be well advised to accept the classic theory until he has seen the machine in operation, and then to make, either from his own observation and researches, or from data which more advanced treatises will supply to him, the necessary allowances forced upon him by the detached operations of exchange market activities, conducted as if they were ends in themselves without relationship to the real end which they serve.

§ 2

Having thus adventured to the edge of deep waters before we have learnt to swim, we can return to a less hazardous vantage point, realizing that beneath the

placid surfaces which writers on the exchanges show to us there are many currents and whirlpools. Our immediate business is to discover by what means the nations settle their differences in trade when they have no exact balance of indebtedness between them. In doing so we shall find that the exchange market and the money market are divided by a very dubious margin, and the study of the one will lead us to a study of the other, and that the technicalities of the one are the jargon of the other.

In Mill's *Principles of Political Economy*, there is an exceedingly lucid account of a simple foreign transaction—

> "A merchant in England, A, has exported English commodities, consigning them to his correspondent B in France. Another merchant in France, C, has exported French commodities, suppose of equivalent value, to a merchant D in England. It is evidently unnecessary that B in France should send money to A in England, and that D in England should send an equal sum of money to C in France. The one debt may be applied to the payment of the other, and the double cost and risk of carriage be thus saved. A draws a bill on B for the amount which B owes to him; D, having an equal amount to pay in France, buys this bill from A and sends it to C, who, at the expiration of the number of days which the bill has to run, presents it to B for payment. Thus the debt due from England to France, and the debt due from France to England, are both paid without sending an ounce of gold or silver from one country to another."

In practice, however, such simplicity is not present. Even if, by some astounding series of coincidences, all the claims on the citizens of all the States could be cancelled out, there would still remain the inconvenience of arranging so huge an operation. And rarely can they be cancelled, even in the broad sense that the total obligations of the citizens of one country to those of another equal the total liabilities of the citizens of that other to the one.

Bills or Gold.

In my capacity as the sole proprietor of the firm of Invisible Paint, Ltd., I have imported from America, let us say, a large supply of tin boxes. I must remit to my American creditor a sum equal to £500. I go into the market to buy a bill. What I really wish is to buy a document which will enable my creditor to draw the amount I owe to him from his neighbour, who owes a similar amount to a neighbour of mine, who will eventually, through the tangle of relationships, receive my money. If, as we saw in the last chapter, there is a bigger demand for bills on America than the supply offers, the bill rate will be high. I shall have to pay more for the document which is to serve my purpose. But, being a hard-headed fellow, I shall buy a bill only if a bill remains my cheapest way of remitting my payment to America. Bills will not cost me, therefore, a higher price than would be the cost of buying and transmitting actual gold. Even so, it may be that the supply of bills is exhausted before I can come by one. Am I then to procure and send the gold? By no means. If there is no bill available for my use in the market, there are many people willing to draw a bill to my specifications, if I will pay for the trouble and risk. Failing to find a trade bill, I can go to my banker and he will supply me with one of the banker's drafts of which we talked in an earlier chapter. The bank which supplies my need must make a fair profit on the accommodation, but it will not make a large profit, for I shall not buy if I can remit more cheaply by sending gold and, in any event, many people are competing for my order for such a bill as I need. The point at which it becomes cheaper for me to send to my creditor the actual metal is known as the **Gold Point.** (Sometimes this is referred to as specie or bullion point.)

The export gold point is given by the rate of exchange represented by the number of units of foreign currency obtained for each £1 laid out in procuring gold at home and shipping it for sale abroad; the import point is the rate obtained by the shipping of gold from abroad for sale here.

Two Pars.

Before we can determine the gold point we must know the exact cost of the total transaction. The various items must be added to or deducted from the price or the proceeds, as the case may be. Thus, the amount of fine gold which is by our Mint laws contained in our sovereign, will make in America $4·8665622. The **Mint Par of Exchange** is that figure—£1 sterling being equal to $4·86⅔. But if I buy gold in London to ship to my tin box maker in America, I cannot merely allow for the purchase price of an amount of the metal which will yield to him the equivalent in dollars of the £500 I owe to him. I must ship and insure and convey to and from the quay, and provide packing cases and several other adjuncts to the business of getting it from one place to the other. The gold point can never be a definite figure, because my small transaction would carry heavier overhead costs of this kind than would some larger transactions.

A sovereign contains as much fine gold as will make $4·86. We may re-state that relationship by saying that in England 113 gr. of fine gold make a sovereign, and in the United States 23·22 gr. of fine gold make a gold dollar. The Mint Par of Exchange, it will be seen, is the number of coins of one country which contain the same quantity of gold (or other agreed metal) as the standard coin in the other country. It must not be confused

with the term **the Par of Exchange**, which is used to denote a state between one country and another when the demand for bills exactly balances the supply, a state which in practice probably never exists. Since we shall now use the word *par* frequently, and as it may be—unlikely as it seems—new to some readers, I will simply define the word by its Latin meaning as "equal." In the phrase "Mint Par" the coins compared are equal in their content of minted metal. In the phrase "the par of exchange," the bills demanded equal the bills available.

As this volume purports to be little more than a primer, I do not propose to harass the reader by entering into the arithmetic employed to determine parities. In *Foreign Exchange Accounting*, by C. Djorup, and *The Finance of Foreign Trade*, by W. F. Spalding, the student can pursue the study on its arithmetical side.

A Legal Ratio.

One point should be carefully borne in mind. The Mint Par of Exchange expresses only a legal ratio. I have said that a sovereign equals \$4·86⅔, inasmuch as the same weight of gold will coin into each by the Mint laws of the two countries, but whether, if we melted down a given number of sovereigns in one crucible and the number of dollars equal to those sovereigns in another crucible, we should obtain two lumps of gold of identical weight and value is doubtful. Some of our sovereigns would be worn and some of our dollars worn, yet each be within the legal margin allowed for wear and tear. As Clare succinctly puts the matter, "The Mint Par depends, in short, not on the coin itself, but on the legal definition of it; not on the sovereign *de facto*, but on the sovereign *de jure*; and if every gold coin in this country

were debased, and every gold coin in France sweated and mutilated, the Mint Par would remain the same. Unless and until the law is altered the Mint Par cannot alter."

The importance of the Mint Par is not so much that it tells us the ratio of the two coins one to another, but that it gives us a datum from which we can calculate the course of the exchange market, knowing when a rate is for or against us.

As we have seen, when an American exporter is able to sell his draft on London at an exchange of $4·86⅝ per £, the assumption under the theory of the exchanges is that the demand for remittances has corresponded exactly with the supply of instruments for remitting. Critics may doubt if this equality ever occurs, but even if it does not the assumption is helpful. What happens when the supply is definitely unequal to the demand? The price of bills, we have said, goes up or down accordingly. But it does not fall or rise above or below the two gold points, nor, on a rising market, will a banker charge me more for my bill than the competitive level. How, then, does the banker fix his price? He must first, obviously, cover the cost of the draft. He must then add his own profit and the profit of his correspondent on the other side of the Atlantic, or wherever it may be. The banker in this regard is handling bills as if they were themselves a commodity. By foresight or trading luck, he may happen to have in stock a supply of London bills which he bought at a lower price. If he meets my desire for such a bill from that stock the rise in price is pure profit to him. But he may have no such stock. He must then find some form of remittance which will satisfy my need and leave him with as large a profit as the competition and the gold point permit. He, therefore,

casts about and buys bills on some other country. These he sends to his correspondents abroad with the instruction that they will remit for his account in London. This operation will involve him in double commission and expenses, and he will not resort to it unless he is working on a broad margin. But the London rate is rising, so to the foreign country he has resort. The first effect will be that the exchange of that country will be made to move in the same direction as that of London. Speaking generally, all exchanges rise together or fall together because of this intercommunication and trade, or all fall together. Only when the credit and finances of a State are in a bad way will its exchange fail to respond.

Driven to Gold.

There may, however, come a moment in this trade when suitable bills can no longer be had in a quantity sufficiently adequate to check the rising rate in the London market. It is then that the banker will be driven to a gold shipment.

A falling rate has the opposite effect. As with any other commodity, a fall in the price will stimulate demand, and a rise will slacken demand, but stimulate supply. A falling rate in one centre lowers the rates in other centres, because bankers will buy cheap paper in London, if London is falling, and will use it to cover their sales of drafts in places which are quoting high. In this process we reach a point when the bankers will use the cheap London paper to buy gold at the Bank of England for shipment at top speed to the foreign capitals where, after payment of the incidental charges of transit and insurance, it will earn a profit.

The whole complex differs in no essential from that of ordinary trade, and the procedure is easy to follow once

it is grasped that the paper is being handled and treated as a commodity and nothing but a commodity by those supplying it, whatever use is made of it by those exchanging it for the purpose of settling trade debts, with the reservation that once the price and cost of shipment rises or falls above or below two certain points it becomes cheaper to remit a second commodity in lieu of the first, that second commodity being gold.

§ 3

If international dealings were being conducted by only a few people, the matter would remain relatively simple. But they are, in real life, being conducted by a multitude of persons, some with one kind of need, some with another ; some of sound credit, some of no credit at all ; some with shipping available at low rates of freight, some with shipping available only at high freightage rates, some having to wait for ships. Importers wishing to buy a bill have to get into touch with exporters having just such a bill to sell. At one time this nice business of finding the exact market for a bill was conducted by a bi-weekly meeting of brokers and bankers. These important persons stood " on 'change " and were, almost literally, the foreign exchange market. The spread and growth of banking, outlined in previous chapters, has, however, simplified the matter to such an extent that to-day the whole business is undertaken and performed by the home and foreign banks and the big finance houses which have their offices in London. A trader to-day has but to instruct his bank, and his exact want is met.

When we looked at the elementary trading which was conducted between myself and my friend, John Doe, we saw how important was the factor of time in payment. That factor is the more important as the sums involved

increase. In foreign trade we have also to allow for another factor. If I, in London, am trading with John Doe, in Staffordshire, and John Doe defaults, my remedy is relatively cheap and simple. I sue him in the County Court. But if I am trading with some obscure fellow in the Argentine and he defaults, I must recover by some process of law with which I am unfamiliar, through channels with which I am not acquainted, and at an expense to which I can fix no anticipatory limits. My instinct would be, in such a case, to send a *pro forma* invoice and get my money in advance. But my customer in the Argentine has no more confidence in me and my national code of laws than I have in him. Before he shows me the colour of his money he wishes to see the shape of my goods. Before either his remittance or my goods can reach their destined recipients, some time must elapse, since both have to cover many miles of space. It may even be that my customer may not wish to pay, and may not be able to pay, for my goods until he has himself sold them to some other trader or to their consumers.

Bill of Exchange.

The difficulties thus arising have been solved by the exploitation of the bill of exchange, the form and legal implications of which we shall examine shortly. In my case I can ship my goods to the Argentine, knowing my customer to be a man of some repute, draw a bill on him and hand it to my bank for collection. The bank takes the bill, transmits it to its own agent in the Argentine, and so obtains my customer's acceptance of it, and secures payment. Alternatively, I can sell the bill to my banker, who will give me a price at a discount which will cover his profit and risk, including cover for the time which

must elapse before he has a return in money for the money with which he parts. (He does not actually give me money, but credits my account with the amount he has given for my bill. For the purposes of this inquiry into my mode of dealing with a foreign customer, however, we can speak of money and credit in this regard as if they were one and the same thing.) But I may not be quite so ready to trust my man in the Argentine. In that case I draw a bill on him in much the same way, but I protect myself by seeing that he cannot have delivery of my goods until the money is safe. What I do is to attach to my bill the documents which the customer will require to clear the goods, including the bill of lading, the insurance policy, the invoice, and the customs certificates.

"D/A" and "D/P."

This is a bill "documents against acceptance," abbreviated in daily parlance to a bill D/A. When the agent of my bank secures the acceptance of my bill, the documents are detached and handed to the customer, who can then secure his goods. If necessary, I can draw a bill on my man, not D/A, but D/P—that is, documents against payment, in which case the documents will be detached and passed to the customer only when he has actually paid the amount owing to me.

There is yet another method by which I can secure my money. I may insist that the customer opens a credit with a known bank or finance house, as explained on page 122.

As an exporter, it will be seen, I have many ways of securing payment by the use of a bill, and all are in addition to what I may perhaps call direct ways of payment, which include a postal packet containing the the currency of my own country, or a similar packet of

my customer's currency, which my bank will exchange at the prevailing rate, or a cheque drawn in terms of my own currency on my customer's account in my own country, or a cheque drawn on my customer's bank in his own country in terms of his own currency. In this last case I can either hand the cheque to my bank, which will collect it, or post it to my agent in the foreign country to be collected there, or sell it to my bank, which will buy it from me at cheque rate.

But suppose the position is reversed, and I have bought goods from my man in the Argentine. He knows little or nothing of my standing, and suggests a bill D/P. I, wishing to turn over the goods before making payment, will find this method fatal to my trade on the deal. From my point of view it is much better that I should open a credit. To do this, as we saw in the earlier chapter, I have but to go to my own bank with the offer of adequate security and to pay the desired commission, and the thing is done. The bank agrees to accept a bill or bills drawn upon it by my supplier in the Argentine in connection with the goods which he has shipped to my order in London. Here, however, we have a choice somewhat similar to that between a bill of exchange in its ordinary state and a bill D/A, for it may be that my bank will insist upon establishing a lien on the goods shipped, in which case the necessary documents will come, not to me, but to my bank, which will release them, and the goods they represent, only when I have fulfilled whatever terms have been arranged between the bank and me when the credit was opened. Such a credit is called a **documentary credit,** as against **a clean credit,** where no such conditions are attached and the security of the bank is given by me in some form not connected with the goods shipped.

Quoted Rates.

Although I propose to postpone an account of how the work of the banks is affected by these buyings and sellings of bills until we have looked at the operations of the Money Market, it is necessary here to note that each day, almost each hour, will see fluctuations in the foreign balances of such houses. As with the cheques and deposits in its domestic sections, the demands and remittances may very largely be left to cancel each other out, but even so they must be carefully watched, and large transactions impose upon the bank concerned the need for immediate action to cover its own interests. As foreign exchange has become more and more of a traffic in a special form of commodity, so the foreign exchange market has become more and more of a market between banks and finance houses rather than between trader and trader, or trader and bank. Even the rates quoted each day in the financial Press are the rates pertaining to the business of the banks and not to that of their customers. Every bank in London whose balance in Paris is getting low, is in the market for francs, as every Paris bank whose London balance is getting low is in the market for pounds sterling. Each bank that buys or sells has not only to effect a deal but has to make the deal effective, that is, it must not only arrange a transaction in currency but must ship the currency which has been bought or sold. Each bank has its own dealer in foreign exchange, whose especial work it is to buy or sell as the trend of the bank's own business dictates. Whatever obligations the bank has undertaken with regard to foreign trade are communicated to him.

Foreign Exchange Broker.

The dealer, in order to buy or sell foreign exchanges, has to make contact with other dealers wishing to effect

the opposite transaction. This he does not by the clumsy and slow method of searching the banks for the dealer who happens at the moment to be his "opposite number," but by the simpler method of using a middleman, **a foreign exchange broker.** The broker has no connection with any bank. His function is to make contact between two dealers each of whom can serve the other's need. For his services he takes a commission. The broker usually, indeed one might safely say always, specializes in one group of foreign currencies only. If a dealer wishes to buy francs he knows to which broker he must apply. If he wishes to buy kroner he knows that some other broker must be approached. The broker, it must be understood, has no personal or direct interest in the transaction. He does not sell to the dealer. Being approached he telephones to other dealers until he finds one who is ready to do business, makes the necessary contact, and retires from the deal. He rings up his dealers and makes a price, that is to say, he quotes the currency concerned within two narrow limits, calling dollars, say, $5\frac{1}{32}$–$5\frac{3}{32}$, which, being interpreted, means dollars at $4{\cdot}85\frac{1}{32}$–$4{\cdot}85\frac{3}{32}$ to the £. This means that he can do business around these limits. He may establish contact between two dealers, one of whom is ready to buy at $5\frac{3}{32}$, and the other to sell at $5\frac{1}{32}$, in which event there is a certain amount of haggling until one or the other changes his figure or both agree to deal at $5\frac{2}{32}$. The broker may have more buyers than sellers, or more sellers than buyers, in which case he must make a market to tempt out more of one or the other.

"T.T."

Once the deal is effected the broker notifies each dealer of the identity of the other and confirms the transaction

in writing at the end of the day to each party. The dealer, having performed his own task of buying currency, notifies the Instructions Department of his bank of the deal. A clerk in that department establishes touch with a clerk in the other bank, states the terms of the deal and discovers the name of the foreign agent to the selling bank who will provide the currency bought. Each bank cables its foreign agent, the one giving authority to pay and the other to receive the sum, and in due course the transaction is completed. Delivery is arranged by cable, and the rates quoted are known as **cable rates,** while the exchange bought or sold is identified as **T.T.,** which is the idiom abbreviation for **telegraphic transfer.** The quoted rates, we have seen, are those upon which the banks themselves are doing business. The customers of the banks will pay a little more or sell at a little less, and thus provide the banks with their legitimate and necessary profit and expenses. Customers transmitting money in haste and having to buy T.T. will be given a rate which may or may not include cost of cable. Much depends on the amount, and a small transaction of this kind will have the cost of cable charged as a separate item. The method of using special code for inter-bank deals prevents the bank from including specific transactions for individual customers in one omnibus cable.

§ 4

We have now seen in outline the various influences which affect the rates of the foreign exchanges. We have seen that it is possible for those handling the exchanges to buy in one market for immediate sale in another where prices are better, and thus make a profit. That profit is called **Arbitrage,** a term which we shall meet again when we examine the stock and share market.

We have seen the effect of supply and demand on bills, and the resultant movements of gold or other bullion. We have also talked of foreign exchange rates. In dealing with these rates a word of warning is needed. The foreign exchange is said to be moving in favour of a particular country when gold may shortly have to be sent there by the foreigners. It is said to be moving against a particular country when gold may shortly have to be exported. When rates are quoted at so many francs or dollars to the pound, the higher the quotation the more favourable the rate for England, since the number of the foreign coins which a pound will buy is greater. Where rates are quoted at so many pounds to the foreign standard coin, the reverse is the case, and the higher the rate the less favourable it is to this country. Where rates are quoted in foreign money a rise or a fall, denoted by high or low, means the opposite of its apparent significance. A high rate in francs is a favourable rate. A falling rate in francs is an unfavourable rate. This gives us two familiar tags of the foreign exchange market. "Buy high; sell low; the better the bill, the lower the rate." "High rates are for us, and low rates against us."

CHAPTER IX

BILLS OF EXCHANGE

BEFORE looking into the operations of the money market and returning to the foreign exchanges for a consideration of their more complicated aspects, we must now give detailed attention to the bill of exchange, that instrument of which we have heard so much in every phase of commercial and financial life which has so far occupied our interest.

A bill of exchange is, perhaps, the most familiar of credit instruments to the foreign trader and the student of commerce, and the least familiar to the ordinary person. The development of the cheque and deposit system, the progressive specialization and efficiency of the banks, and several other changes of commercial habit and practice have forced the bill of exchange from the place it once occupied in domestic trade. This change is not, as some have supposed, an effect of the disruption of the war years. When, over twenty years ago, I was inducted into the practical work of conducting company audits in Lancashire, the bill book had already become a rarity amongst the traders whose accounts I helped to examine, and although I " stood " for some years on a northern produce exchange I never found bills used in settlement of account. None the less, it is not without the limits of commercial probability that the bill of exchange may return to more general use in the future, and those students of commerce and finance whose own exertions are likely to be confined to home trade cannot afford to neglect the mastery of the bill and its uses.

Legal Definition.

A bill of exchange is defined by Sect. 3 of the Bills of Exchange Act of 1882, as follows—

1. A bill of exchange is an unconditional order in writing, addressed by one person to another, signed by the person giving it, requiring the person to whom it is addressed to pay on demand or at a fixed or determinable future time a sum certain in money to or to the order of a specified person, or to bearer.

2. An instrument which does not comply with these conditions, or which orders any act to be done in addition to the payment of money, is not a bill of exchange.

3. An order to pay out of a particular fund is not unconditional within the meaning of this section ; but an unqualified order to pay coupled with (*a*) an indication of a particular fund out of which the drawee is to reimburse himself or a particular account to be debited with the amount or (*b*) a statement of the transaction which gives rise to the bill, is unconditional.

4. A bill is not invalid by reason—

(*a*) That it is not dated.

(*b*) That it does not specify the value given, or that any value has been given therefor.

(*c*) That it does not specify the place where it is drawn or the place where it is payable.

Sect. 9 of the Act of 1882 provides that—

1. The sum payable by a bill is a sum certain within the meaning of this Act, although it is required to be paid—

(*a*) With interest.

(*b*) By stated instalments.

(*c*) By stated instalments, with a provision that upon default in payment of any instalment the whole shall become due.

(*d*) According to an indicated rate of exchange or according to a rate of exchange to be ascertained as directed by the bill.

2. Where the sum payable is expressed in words and also in figures, and there is a discrepancy between the two, the sum denoted by the words is the amount payable.

The form of a bill is left to the choice and discretion of the person drawing, but custom has evolved a common form which is almost always employed. Of this form the following are specimens—

MANCHESTER.
12th *August*, 1929.

Stamp	Three months after date pay to { me or my order / Thomas Atkins or order / bearer } the sum of five hundred pounds for value received.

WILLIAM SMITH.

To John Robinson, Esq.,
44 High Street, London.

MANCHESTER.
12th *August*, 1929.

Stamp	£500. On demand pay to John Robinson or order the sum of five hundred pounds for value received.

WILLIAM SMITH.

To P. Mann, Esq.,
Glasgow.

It will be seen that the bill of exchange bears a stamp. In order to clarify first things first, I propose to inflict upon the reader a quotation from the Finance Acts of 1918 and 1899 as they affected the Stamp Act of 1891.

The Act of 1918, Sect. 36, subsec. 1, lays down that—

> " Two pence shall be substituted for one penny as the stamp duty on all bills of exchange and promissory notes chargeable under the First Schedule of the Stamp Act, 1891, with duty at the rate of one penny and drawn on or after the first day of September, 1918, and two pence shall accordingly be substituted for one penny in Sects. 34 and 38 of the Stamp Act, 1891."

This change affects: (1) All bills of exchange, including cheques and dividend warrants, payable on demand or at sight or on presentation, or not exceeding three days after date or sight; (2) all bills of exchange of any other kind, and all promissory notes of any kind whatever (drawn, or expressed to be payable, or actually paid or indorsed, or in any manner negotiated in the United Kingdom) where the amount or value of the money for which the bill or note is drawn or made does not exceed £5 (five pounds). This Schedule was extended by the Finance Act, 1899, Sect. 10, subsec. 2, to include bills payable at a period not exceeding three days after date or sight, and by Sect. 10 of the Revenue Act of 1909, Sect. 34 and 38 of the Stamp Act of 1891 were brought into agreement with this extension.

We thus get by enactments the following rates of stamp duty on various bills—

	s.	d.
Where the amount or value of the money for which the bill or note is drawn or made does not exceed £5 .	0	2
Exceeds £5 and does not exceed £10	0	2
,, £10 ,, ,, ,, £25	0	3
,, £25 ,, ,, ,, £50	0	6
,, £50 ,, ,, ,, £75	0	9
,, £75 ,, ,, ,, £100	1	0
,, £100, for every £100, and also for any fractional part of £100, of such amount or value	1	0

§ 2

In order to grasp the exact method by which credit is mobilized by the bill of exchange, and to discover the various rights and risks which attach to it we will follow an imaginary transaction.

Accepting a Bill.

As the head of the flourishing firm of "Invisible Paint, Limited," I import a large amount of raw material from

a firm of suppliers in Germany. This firm always wants prompt cash for the goods it sends, but my customers, who are, in the main, you will recall, the dotters of double-blank dominoes, invariably keep me waiting for my own money. Upon one of my own customers, Messrs. Black and White, of Nottingham, I have to draw a bill. I draw it in the form shown on an earlier page, instructing Messrs. Black and White to pay to me or my order the sum of £100 ninety days after the date of the bill. This bill I send with the invoice and delivery note for the paint supplied to Messrs. Black and White, who keep the delivery note, get their paint, and write across the face of the bill over their signature the word " Accepted " or

ACCEPTED *12th August*, 1929. Payable at *Brooks's Bank; Nottingham.*

For and on behalf of *Black and White, Ltd.*,
John Dabster, Secretary.

Whether I send the bill and documents direct or through my bank is a matter of no import. The procedure is the same.

To this point I am **the drawer** of the bill. Black and White are **the acceptors.** Before accepting they were **the drawees.**

Black and White having accepted the bill, I can now pay my German creditor for the raw material with which he supplied me for my invisible paint. I take the bill to my bank, which purchases it. The bill is drawn for £100, but naturally my bank will not give me that sum for it. The bank has to allow for the interest on the money over the period of days which it has to run, and calculates that interest at the rate then obtaining. Ninety-three days (not ninety) after the date of the bill the then holders, who may or may not be the bank which

bought it from me in the first place, will present it to Brooks's Bank at Nottingham for payment. Brooks's Bank at Nottingham will pay the bill, and will debit the account of its customers, Messrs. Black and White, the acceptors.

The Banker and the Bill.

The bank, I may mention in passing, has an **Acceptors' Ledger** in which a separate account is opened for each acceptor of bills discounted by that bank. From this the banker is able to see at a glance the amount for which the acceptor is already liable, knowing to what extent the acceptances of any person or firm have been discounted.

When Black and White accepted the bill it was then good evidence of debt as between them and me, but no more than that. When the bank bought it from me at a discount it became an ordinary credit instrument. A broker needing a bill of that kind on that town would be able to purchase it from the bank and sell it to his own customer, who might re-sell it to someone else who also re-sold it. In its passage from one holder to another the bill becomes, as it were, a piece of unofficial currency.

When the bank buys the bill from me I endorse it, that is, I write my name on the back, the acceptance being across the face. Every time the bill changes hands the holder who parts with it endorses it in the same way. What, then, are the liabilities undertaken in this process? The person primarily liable for meeting the bill is the acceptor, but if he defaults the liability extends back through the chain of endorsements. My bill, not having been met by Black and White when presented by Snooks and Company, who had it from Mavis, Mavis, Thrush and Mavis, the solicitors, who had it from the Bank of Muddleboro', who had it from me, Snooks and Company

recover from Mavis, Mavis, Thrush and Mavis, who recover from the Bank of Muddleboro', who recover from me, leaving me to settle finally with the defaulting acceptors.

A Negotiable Instrument.

Since the bill passes from hand to hand in this way it is **a negotiable instrument.** A negotiable instrument is distinguished by two characteristics. It is transferable by delivery, and delivery establishes a sound title. That which is transferable by delivery demands no registration of its passing. No deed nor form of documentary "transfer" is needed. If I choose to sell to you the rather rare seal which adorns my watch fob I have merely to detach it, hand it to you, take your money, give you a simple receipt, and the transaction ends. The seal is yours. But if I choose to sell to you my ancestral estate, no such simple process applies. Our lawyers grow rich by the preparation of the requisite deeds registering the transfer of my inherited acres. Similarly, if I sell my shares in a company, a transfer form is necessary and a change in the share register. But a bill of exchange is not even burdened in transfer by a simple receipt, as was the seal from my watch fob. You give me the money, I pass to you the bill, and legally the bill is yours. If, for example, I had stolen the seal which you buy from me and its real owner discovers it in your possession, he can, by law, compel you to return it to him, although you bought it in good faith. But if I receive a bill of exchange for a debt which is not due to me from my trusting friend, Rupert Jenks, and you pay me a price for it, Jenks cannot take action against you. Your title to the bill, although given by me, who had no sound title to it, is good. You, having bought the bill in good faith, for value, and not

knowing that I had no good title to it, have become "**the Holder in Due Course.**"

A cheque is nothing more or less than a simple bill of exchange drawn on a banker, payable at sight, but if crossed "not negotiable," it is deprived of that characteristic which enables mere delivery to pass a good title, for the title of any holder is no better than that of the person from whom it was received.

Discounting.

When I took the bill, which Black and White had accepted, to my bank, I was able to sell it, but not at its face value. As we saw, the bank discounted my bill. The process of sale with bills is known as "discounting" or "negotiating." The calculation of the price which the bank paid to me, we also saw, was based on the interest on the amount of the bill for the period it had to run. That interest is known as discount, and the price of a bill is always quoted in terms of the rate of discount which will be deducted from it.

My bill, drawn on and accepted by Black and White, was a **trade bill**. A trade bill is simply a bill drawn on and accepted by a drawee who is not a bank. A ninety day bill is a three months' bill. When the three months' bill rate is quoted it should be noted that the rate is not a flat percentage. If my bill is discounted at $5\frac{1}{2}$ per cent it is discounted at the rate of $5\frac{1}{2}$ per cent per annum on the three months' period. I do not get for it £94 10s., but £98 12s. 6d. At 5 per cent I should not get £95 but £98 15s. The sum is arrived at by using the three months as a fraction of the year in this way—

$$\begin{aligned} \pounds 100 \text{ minus } \frac{100 \times 10 \times 1}{100 \times 2 \times 4} &= \pounds 100 \text{ minus } 1\tfrac{1}{4} \\ &= \pounds 100 \text{ minus } \pounds 1\ 5\text{s. } 0\text{d.} \\ &= \pounds 98\ 15\text{s. } 0\text{d.} \end{aligned}$$

§ 3

Bills may be drawn at various periods. A bill drawn at sight must be paid on presentation. Such a bill is known as a **Sight Draft.** Bills for longer periods may be either after sight or after date. If a bill is drawn for eight, thirty, sixty, ninety days, as the case may be, it will read either "At eight days after sight pay . . ." or "Eight days after date pay to . . ." In the first case the bill is to be met eight days after it is accepted. In the second case it is to be met eight days after dating, although some of those days may have passed before the bill is sighted and accepted by the person on whom it is drawn. As we noticed in passing, a bill is given three days of grace in addition to its nominal period. A ninety day bill is payable ninety-three days after sight or date, whichever it may be. The date of a bill, as we saw from the Act of 1882, must fix or indicate a determinable future. A bill cannot be drawn "ninety days after the arrival of the ship 'Psyche' pay to . . ." but it can be drawn payable on a person's death, which must sometime occur. The date when the bill is actually due for payment is known as "**maturity.**" A ninety-day bill drawn to-day matures ninety-three days hence.

It should also be noted that just as a cheque is a form of bill of exchange, being a sight draft drawn on a banker, so many sight drafts are loosely called cheques, New York cheque rate being used to denote rates for sight drafts on New York, and so on. Bills are generally spoken of as "paper"—**trade paper** meaning ordinary trade bills, and **bank paper** meaning bills accepted by banks or accepting houses, with whose functions we shall deal shortly when we survey the money market as a whole.

Bills "In a Set."

Foreign bills are usually drawn "**in a set,**" that is, drawn in several parts. By transmitting the various parts by separate mails an extra measure of safety in transit is secured. When a bill is drawn in two parts one may be sent immediately to the drawee for acceptance while the second part is negotiated. The negotiated second part will contain a reference to the accepted part in the possession of a known firm phrased in this way: "First and in need with Brooks's Bank, London." If the bill is not met, the agents named in this reference will, after it has been protested for non-payment, meet the bill for the honour of their principal. Only one part of a set requires a stamp, and upon proof of the destruction or loss of a duly stamped bill forming one of a set, any other bill of the set which has not been issued or negotiated apart from the destroyed or lost bill may, even though unstamped, be admitted in evidence to prove the contents of the lost or destroyed bill.

A bill drawn in a set of three consists of three instruments all couched as follows, save that in the context and reference to the "same tenor and date unpaid" the words first, second, and third are altered according to which part is affected.

(First Part) MANCHESTER.

12th August, 1929.

£500.

Ninety days after sight pay this first of exchange (second and third of the same tenor and date unpaid) to the order of John Robinson the sum of five hundred pounds for value received.

WILLIAM SMITH.

To Cyprus K. Hanks,
New York.

The foreign bill, as distinguished from the inland bill (drawn and payable within the British Isles or drawn

within, and upon persons ordinarily resident in, the British Isles, not including the Irish Free State), is obviously subject to different conditions as to rights and liabilities from those outlined above. A foreign bill may be of two kinds, one drawn in this country but payable abroad, or one drawn abroad but payable here. Bills payable abroad are sent, as a general rule, to a London bank for sale to or through a foreign bill broker. A foreign bill which is dishonoured either by non-acceptance or non-payment must be "**protested**" and after protest the usual steps taken for recovery. The procedure of protesting a bill either for non-acceptance or non-payment involves recourse to a notary public, who issues a certificate which is known as a protest. The bill is handed to the notary public who presents it again to the drawee or the acceptor, and if payment or acceptance is not then obtained, a note of the facts is made upon or attached to the bill. This is known as **Noting** the bill.

The drawer or an indorser of a bill may insert in it the name of a person to whom the holder may appeal in case the bill is dishonoured either as to acceptance or payment. Such a person is called the **referee.** If the drawee refuses to accept the bill or to pay it, the bill may be presented to the referee, who, if he accepts it, becomes the **acceptor for honour.** He makes himself fully liable for the obligations of the person whose place as drawee or acceptor he takes.

Where Laws Conflict.

The rights, duties and liabilities of all parties to a foreign bill are set out in Sect. 72 of the Bills of Exchange Act, and are determined as follows—

1. The validity of a bill as regards requisites in form is determined by the law of the place of issue, and the validity

as regards requisites in the form of the supervening contracts, such as acceptance or endorsement, or acceptance *supra* pro test, is determined by the law of the place where such contract is made :

Provided that—

(*a*) Where a bill is issued out of the United Kingdom it is not invalid by reason only that it is not stamped in accordance with the law of the place of issue.

(*b*) Where a bill, issued out of the United Kingdom, conforms, as regards requisites in form, to the law of the United Kingdom, it may, for the purpose of enforcing payment thereof, be treated as valid as between all persons who negotiate, hold, or become parties to it in the United Kingdom.

2. Subject to the provisions of this Act, the interpretation of the drawing, endorsement, acceptance, or acceptance *supra* protest of a bill is determined by the law of the place where such contract is made :

Provided that where an inland bill is endorsed in a foreign country the endorsement shall as regards the payer be interpreted according to the law of the United Kingdom.

3. The duties of the holder with respect to presentment for acceptance or payment and the necessity for or sufficiency of a protest or notice of dishonour, or otherwise, are determined by the law of the place where the act is done or the bill is dishonoured.

4. Where a bill is drawn out of but payable in the United Kingdom, and the sum payable is not expressed in the currency of the United Kingdom, the amount shall, in the absence of some express stipulation, be calculated according to the rate of exchange for sight drafts at the place of payment on the day on which the bill is payable.

5. Where a bill is drawn in one country and is payable in another, the due date thereof is determined according to the law of the place where it is payable.

There is an old-established and very English custom whereby English traders often draw on their foreign customers not in the currency of the customers' country but in pounds sterling. Psychologically this is akin to the habit, still prevalent amongst certain traders, of sending abroad catalogues quoting in sterling. Such bills are made payable at a rate of exchange to be endorsed

in London. Their form varies from the common form by the addition of the words after the sum to be paid "at the rate of exchange as per first London endorsement." This custom arose from a reluctance on the part of drawers to risk loss from fluctuations beyond his calculations and foresight, and bills so drawn do enable the drawer to match the exact amount of his invoice, which, following the sterling quoting catalogue, is quoted in that way to avoid either the addition of a margin as cover against fluctuations or a constant revision. When such a bill is sold the endorsement runs: "Pay So and So, or order, at the exchange of \$4·86⅝ to £1 sterling."

Foreign Domiciles.

In addition to bills drawn by foreign exporters on and accepted by British traders or by London banks, there come into the London market other and more complicated bills. The straightforward bill enables any injured party to place himself in touch with the other parties. A bill not quite so straightforward offers some difficulties. Let us suppose that a German shipper draws for his produce on Berlin on the understanding that payment will be made in London. The bill is sent to the German capital for acceptance, will be made payable in London, and sent to the English capital addressed to the agency of the bank which negotiated it at the other side of the water. Such a bill is the acceptance of a continental firm, and may carry a series of continental endorsements These bills are known as "**foreign domiciles**," and are not liked by the London market. The Bank of England has always refused such paper and has never discounted it, no matter what might be the standing of its endorsement. Quite recently such paper has been deprived of discounting generally in London. In a similar category

are " **foreign agencies,**" which are bills accepted by the London branches and agencies of continental banks or foreign firms established in London. As the assets of such houses are mainly abroad, they do not offer good security in the event of the dishonour of the bill. Discount rates for such paper are usually $\frac{1}{16}$ or $\frac{1}{8}$ per cent higher than the rates for first class English domicile bills.

We shall see in a later chapter how all foreign bills are handled by banks, accepting houses, and brokers, in the money market.

CHAPTER X

THE MONEY MARKET

A CHESTERTONIAN love of paradox might well lead one to explain the term "the Money Market" by saying that no market exists and that the persons concerned do not traffic in money. Otherwise the name is accurate. By this would be meant that there is no specific place or building where the buying and selling of money goes forward, and that those who conduct dealings on the mythical floor of the mythical market are less concerned with money, in the normal use of the word, than with various forms of credit.

The money market is the term we apply to the community which includes the Bank of England, the London bankers, the stock and share brokers, the bill brokers, and all dealers in money and credit, whether they be lenders, borrowers, or middle-men. Bagehot, and many another after him, found a considerable volume not too large for the description and discussion of the money market. William Thomson manages in his *Dictionary of Banking* to give a very fair account of it in some twenty-five lines. His description of its functions is short but illuminating.

" . . . The bankers collect money from all over the country and such surplus as is not required for current purposes is lent on the market for various periods, and all the operations between the bankers, brokers, and discount houses constitute the business of the money market. If there is a large supply of money and the demand for loans is small the rates charged will be low, but if, on the other hand, the supply is small and the demand large, the rates will be high. When the Government is in need of a temporary loan it sometimes becomes a

borrower in the money market upon Treasury bills. Money is occasionally lent to the market by the Indian Government for short periods. The money market is often referred to as 'Lombard Street.'"

We have seen in preceding chapters that the evolution of our monetary system has brought about a state of day to day affairs in which every one, knowing that his debt can legally be demanded in cash, is satisfied to take in payment some form or another of credit instrument. We have seen how credit was first organized and to what a pitch of efficiency its organization has now been brought. Although since 1914 gold in the form of coins cannot be demanded, and since 1925 only certain quantities of bulk gold can be demanded, we are still in theory basing all our transactions upon the knowledge that in the last resort we can ask gold in exchange for our claims upon society, and, if not gold on demand, can always have legal tender in the form of bank-notes. (The Treasury notes which were introduced during the war years were withdrawn in November, 1928, when the whole note issue became again the function and responsibility of the Bank of England. Bank-notes are legal tender.) Within certain limits, designed to protect the convenience of the creditor or borrower, coins of silver or bronze can also be demanded, those limits being forty shillings in silver and one shilling in bronze.

The credit instruments are not, we have seen, legal tender. They cannot be forced upon a creditor by his debtor. Cheques, drafts, bills of exchange, promissory notes, all pass only in the belief that the standing of the responsible party to them is able at a given time to ensure their exchange for cash.

Gold, bank-notes, credit instruments of all kinds, are the commodities of the money market. How are they handled?

Lenders and Borrowers.

Dominating, watching, controlling, and stabilizing the money market is the Bank of England. The lenders are represented by the great banks, known as "the Big Five," which include Barclays, Lloyds, the Midland, the National Provincial, and the Westminster Banks, with a number of other great clearing banks, like Martins, many of which, in addition to their participation in the London money market, are the organizers of special forms of credit in the big provincial centres which deal in special commodities. In addition there are the London offices of imperial and foreign banks and the accepting houses, of whom the house of Rothschilds is the most familiar example. The borrowers are represented by the discount houses, dominated by "a big three" in the identities of Alexanders, the Union, and the National Discount Companies, but comprising several other firms. These houses borrow from the banks generally for short periods on cheap terms to finance their business of buying and selling bills of exchange. The stream of funds which pours into the market through the contributory channels of the banks is thus diverted to new uses in the fertilization and irrigation of commerce and trade all over the world. The money market is not unlike, to take a concrete analogy, those mechanisms which supply certain factories with water, spray it through the air after its temporary use, and return it again in usable form to its original source.

We have already, in Chapters V and VI, examined the rise and functions of a central bank. We saw that by Peel's Bank Act of 1844 the Bank was divided into two departments, an Issue department and a Banking department, and that there followed the gradual segregation to that bank of the right to issue notes, which was

exercised under certain restraints. The fiduciary issue—that based on credit—was first fixed at £14,000,000, and any notes issued in excess of that amount had to be backed by an equal amount of gold, except that silver to the extent of one-fourth of the gold could be, but never was, included. As we saw, however, the Bank was allowed to increase its fiduciary issue up to two-thirds of the right of issue lost or renounced by a country bank. The fiduciary issue by this process, after seventy odd years, became fixed at £19,750,000, until the transfer of Treasury notes. It now stands at £260,000,000. Against this issue there is the backing of the Government Debt and Other Securities.

The Bank Rate.

The Bank of England is not an official institution, but enjoys almost equivalent powers and prestige. Its responsibility for the management of the currency exercised before November, 1928, has since that date been widened to include more than management, although the Bank cannot increase its circulation except by increasing its stock of gold. It could increase its stock of gold by offering a strong inducement to all holders of the metal to deposit it. If the Bank raised its rate of discount, holders of gold would bring it in, in the firm expectation of finding a new investment for it at a higher rate. Equally, when the stock of gold was adequate, the rate had but to be lowered and it no longer paid anyone to import more of it, as we saw when looking at the gold points in the earlier chapter on the foreign exchanges. If the Bank would not lend money save at a high rate of interest, money was not much borrowed. If the Bank would lend at a low rate, money was widely borrowed. And the Bank was affected towards a higher or lower rate according to the state of the

exchanges. If there were here a large stock of gold, the rates of exchange would be in favour of this country. When they reached a point which attracted the import of gold, the *Bank Rate* would be dropped and the incoming gold discouraged. When the stock of gold was low, the exchange against us, then the Bank rate would rise and the export be discouraged.

In the chapters on banking we saw how the Bank and the Government were at times compelled to act in concert to prevent runs on the supply of gold, by condoning the issue of notes beyond the legal limits on the strength of a Chancellor's letter and the promise of a Parliamentary amnesty.

The Bank Return.

Each week the Bank of England issues a return. This is demanded by the Act of 1844, Sect. 6, of which lays it down that—

> " An account of the amount of Bank of England notes issued by the Issue Department of the Bank of England, and of gold coin and of gold and silver bullion respectively, and of securities in the said Issue Department, and also an account of the capital stock, and the deposits, and of the money and securities belonging to the said Governor and Company in the Banking Department of the Bank of England, on some day in every week to be fixed by the Commissioners of Stamps and Taxes, shall be transmitted by the said Governor and Company weekly to the said Commissioners . . . and shall be published by the said Commissioners in the next succeeding *London Gazette*, in which the same may be conveniently inserted."

This return is published on Thursdays and is made up to the close of business on the previous day. The week which began on 3rd August, 1914, saw a variation in this practice, the return being issued to the evening not of Wednesday the 5th, but Friday the 7th, a delay said by some critics to have been due to the need to conceal the

violation of the Bank Act under the stress of political conditions.

Specimens of this return will be more enlightening than a description, and I append four of them, that for September, 1844, the year of the Act, that for 23rd June, 1909, a specimen pre-war year, that for 7th August, 1914, and that for 28th November, 1928, the week after the Treasury note issue had been transferred to the Bank.

BANK OF ENGLAND

An Account for the Week ended on Wednesday, the 7th day of September, 1844

ISSUE DEPARTMENT

	£		£
Notes issued . .	28,351,295	Government debt .	11,015,100
		Other securities .	2,984,900
		Gold coin and bullion.	12,657,208
		Silver bullion . .	1,694,087
	£28,351,295		£28,351,295

BANKING DEPARTMENT

	£		£
Proprietors' capital .	14,553,000	Government securities	14,554,834
Rest. . . .	3,564,729	Other securities .	7,835,616
Public deposits* .	3,630,809	Notes	8,175,025
Other deposits . .	8,644,348	Gold and silver coin .	857,765
Seven day and other bills . . .	1,030,354		
	£31,423,240		£31,423,240

BANK OF ENGLAND

An Account for the Week ended on Wednesday, the 23rd day of June, 1909

ISSUE DEPARTMENT

	£		£
Notes issued . .	57,706,245	Government debt .	11,015,100
		Other securities .	7,434,900
		Gold coin and bullion	39,256,245
	£57,706,245		£57,706,245

BANKING DEPARTMENT

	£		£
Proprietors' capital .	14,553,000	Government securities	15,368,812
Rest . . .	3,107,086	Other securities . .	30,707,163
Public deposits* .	13,409,696	Notes . . .	28,328,680
Other deposits . .	44,890,022	Gold and silver coin .	1,602,809
Seven day and other bills . . .	47,660		
	£76,007,464		£76,007,464

BANK OF ENGLAND

An Account for the Week ended on Friday, the 7th day of August, 1914

ISSUE DEPARTMENT

	£		£
Notes issued . .	44,491,070	Government debt .	11,015,100
		Other securities .	7,434,900
		Gold coin and bullion	26,041,070
	£44,491,070		£44,491,070

BANKING DEPARTMENT

	£		£
Proprietors' capital .	14,553,000	Government securities	11,041,152
Rest . . .	3,547,083	Other securities .	65,351,656
Public deposits . .	11,499,452	Notes . . .	8,385,650
Other deposits* .	56,749,610	Gold and silver coin .	1,580,999
Seven day and other bills . . .	10,312		
	£86,359,457		£86,359,457

* Including Exchequer, Savings Banks, Commissioners of National Debt, and Dividend Accounts.

Before reproducing the recent return, which is slightly changed in form, I will touch briefly on some of the items shown above in the accounts. The Issue Department's account is perfectly simple. The two items " Government Debt " and " Other Securities " together form the backing to the fiduciary issue. The Banking return shows first Proprietors' Capital, which explains itself, followed by the mystic word " Rest." This is merely the undivided

profit, and is never allowed to fall below £3,000,000, the surplus above that amount furnishing the half-year's dividend. The figure against Rest does not, of course, include hidden reserves. Public Deposits (see Chapter XIX) are a baffling item, and must be set off against Government Securities. These deposits are seen to rise when the taxation periods are at their climacterics, and to fall when heavy Government interest is paid on stocks. The Government's overdraft—that is the "Ways and Means" advances—are the subject of a special statement. The Other Deposits include both the ordinary deposits of private customers and the deposits kept by the other banks. The seven day bills are the "**Bank Post Bills**" issued by the bank itself. They are issued to the Bank's customers free of stamp duty and commission. They are not a great item, but are chiefly used by travellers who are going abroad, and for occasional domestic transfers.

The "Proportion."

On the other side we have Government Securities, to be set off against Public Deposits as a mysterious item. Other Securities as an entry represents the vital item of borrowings from the Bank by other banks, its own customers and the money market at large. It includes loans against securities and bills discounted. The items Notes, and Gold and Silver coin constitute the reserve which is the amount of ready cash in the till for meeting calls and repayments. The percentage which this reserve bears to the liabilities to the public is known as **the proportion,** liabilities in this context excluding the commitment under Proprietors' Capital and the Rest. The proportion is the immediate index to the position of the bank. At one time if the proportion fell to as low a figure as 30 per cent, the danger line was felt to be near, and a

rise in the Bank rate was looked for, but post-war custom has permitted the proportion to fall as low as 15 per cent without causing any alarm.

When in 1914 the Treasury was empowered to issue notes in any manner and amount that it decided necessary, the position of the Bank was not in principle changed, although its practice had perforce to be modified. There were two ways of regarding the new issue, either as a change in the form of the currency or as a widespread war loan free of interest. As this is not a history of war time currency we may omit the period between 1914 and 1928 at this stage of our inquiry and concentrate only upon the amalgamation of the Treasury note issue with the Bank issue in November, 1928. A week after the appointed day for that amalgamation the Bank issued its customary return under the Act of 1844. In comparing that return with previous returns one or two points should be borne in mind. In 1925 the nation had returned to the gold standard. The legal embargo on the export of gold was abandoned as from the 31st December of that year, and from the date of the Budget—28th April—licences to export were freely given. The circulation of gold coinage was not resumed and the Bank was no longer obliged to pay gold coin £ per £ on its own notes. It had the option of so doing, but was under no compulsion, but it undertook to sell on demand standard gold in bars of not less than 400 oz. at the Mint price of £3 17s. 10½d. per oz., and to buy any gold offered at not less than £3 17s. 9d. per standard oz. Anyone could thus obtain bullion, but not specie, and the right of the bullion holder of coinage at the Mint was withdrawn. In the return for 28th November, 1928, there was an innovation for the first time since 1844, and its nature will be seen by a comparison with the returns printed above.

BANK OF ENGLAND

An Account for the Week ended on Wednesday, the 28th day of November, 1928

Issue Department

		£			£
Notes issued—			Government debt		11,015,100
In circulation		367,001,148	Other Government securities		233,568,550
In banking department		52,087,797	Other securities		10,176,193
			Silver coin		5,240,157
			Amount of fiduciary issue		260,000,000
			Gold coin and bullion		159,088,945
		£419,088,945			£419,088,945

Banking Department

		£			£
Proprietors' capital		14,553,000	Government securities		52,180,320
Rest		3,254,001	Other securities—		
Public deposits— (including Exchequer, Savings Banks, Commissioners of National Debt, and Dividend Accounts)		21,452,051	Discounts and advances	£13,586,293	
Other deposits—			Securities	20,214,855	33,801,148
Bankers	£62,379,409		Notes		52,087,797
Other accounts	37,185,203	99,564,612	Gold and silver coin		757,048
Seven day and other bills		2,649			
		£138,826,313			£138,826,313

The Issue Department.

The changes in the form of the Bank Return were to some extent foreshadowed in Clause 10 of the Currency and Bank Note Act " to such extent as the Treasury, with the concurrence of the Bank, consider necessary, having regard to the provisions of this Act." What are those changes? Let us look first at the issue department. The notes issued are now sub-divided. That sub-division actually gives us no new information. The item " Notes in Banking Department " is only a cross-entry from the return of the banking department. The value of the sub-division is that it is a convenience to have the notes actually in circulation shown separately. Notes in circulation, it is well to remember, include notes which are actually behind the counters of other banks as well as those in the pocket-wallets of the public.

On the other side of the return of the issue department the changes are more significant. The first item is " Government Debt." That is the debt of the Government to the Bank. The two next items correspond to the " Other Securities " of the old return. The new return tells us how much is Government securities and how much other investments, although there is no guide to what kind of securities are called " Other." In this section there is one important point to be borne in mind. There is no reason why one type of security is held in the issue and another in the banking department, except as the Bank, for its own convenience, decides. Under the Act the profits of the issue department go to the Treasury. The Bank will, therefore, adjust its earning assets between its two departments in a measure calculated to yield to the Treasury a profit neither too big nor too small. It will transfer securities from one department to the other. The new sub-division in the return of the issue department

must be read with the figures under the same heads in the return of the banking department, where the distinction has always been made. By the new return we are able to classify accurately the holdings of the Bank, whereas under the old return it was unknown whether a particular block was of Government or other investments.

The item " Silver Coin " is an assurance that silver is not part of the metallic backing of the note issue.

The Banking Department.

The return of the banking department in its new form is very much clearer as to the actual position than it was under the old form. The item of " Other Deposits " is divided to show separately the deposits of bankers. The Governor of the Bank of England has admitted that " bankers " is rather an elastic term, but here it includes, one assumes, the London clearing banks, provincial, Scottish, and Ulster banks, and any house whose primary function is deposit banking. The knowledge of the amount of bankers' deposits, plus a knowledge from the banks themselves, of how much of their cash items is " Balances at Bank," is a clue to the mystery of the whole credit situation of the country.

On the other side of the return we find that the item " Other Securities " has there been sub-divided to show the market indebtedness to the Bank by the revelation of " discounts and advances." When the market discounts a bill at the Bank, the Bank treats the operation as a " discount," but when the Bank, for its own purpose and by its own open market policy buys bills, they become securities, Treasury bills being " Government " and commercial bills being " other." From this division two facts can be deduced, the state of the money market and the progress of the open-market policy of the Bank itself.

A Step Forward.

The new Return is a great step forward from the old, and is an example of the potentialities for internal reform inherent in the constitution of the institution. The Return still lacks, however, some points of information which would be of value. The item in the banking department, "Government Securities," might well be analysed, and the nature of the "securities" could also with benefit be indicated. A similar indication of the nature of the "Other Securities" in the issue department would also be welcome. Before 1844 the published Return actually gave a detailed specification of public deposits, other deposits, Government securities, and other securities. This specification was absent from the Return after 1844, and might well be present in contemporary returns. But, even so, the Return as now issued is infinitely more useful than the returns between 1844 and December, 1928, When the Snowden Committee on Banking and Credit, which was appointed in October, 1929, reports, it is possible that the form of the Return may again be changed, and the further information above indicated included.

Bank Balance Sheets.

Chief among the lenders, as we have seen, are the big joint-stock banks. The balance sheets of these banks show on the one side items against capital, reserves, deposits and notes, and on the other side against cash, balances with other banks, call-money, bills, investments, advances, and premises. The cash holding in our times includes little if any gold, the supply of bank-notes and silver and bronze coins calculated to meet the day's needs, and the balance of that particular bank with the Bank of England, this last item being the partial equivalent to the "Other Deposits" in the bank return.

As we have seen in an earlier chapter, the claims held and presented by and to the various banks are cancelled out in the Clearing House, and only the differences transferred. It is to meet such differences that the banks keep their balances at the Bank of England. When there comes a cheque drawn upon a bank in favour of the Bank of England itself—a customer having bought therefrom either bullion or securities—the clearing bank's balance is debited direct with the amount. The balances with other banks will include cheques paid in but awaiting collection, and money with foreign banks. Call-money is money lent at a day's or a week's notice on the money market or to stock dealers for the account. When a bank manager surveys his position each morning he finds that he has money in hand over and above his requirements, and lends his surplus to the market, but as his own requirements vary from morning to morning he lends at short period call. He may at any moment refuse to renew these loans, and in so doing is said to "call his loans." He may, on the other hand, be only too anxious to employ his surplus, and will then offer money to the market at whatever rates will bring business. An increase in deposits will thus lower the rate for call-money, and an anticipation of heavy withdrawals will raise it. Bills we have already examined, and it only remains to be said in this connection that the bank, when it wishes to reduce its holding, merely allows bills to mature without buying fresh paper. Investments and advances we have also examined, and the item for premises is self-explanatory.

Finance and Accepting Houses.

The finance and **accepting houses**, whose function is so similar to that of the joint-stock banks, play two

main parts in the business of the market. They will accept a bill on behalf of their customers all the world over, and by so doing will make an unknown bill into first-class London paper. For this service they receive an agreed commission. They also assist in the floating of **Foreign Loans**, including the undertaking of the necessary exchanges of the sterling raised by the flotation into the currency of the borrowing country. In addition to these tasks they buy and hold bills, open credits and lend money at call. Although the joint-stock banks now do an increasing amount of accepting business, the merchant bankers are the main pillars of this part of the market.

The bill brokers, as we saw in the last chapter, are the middlemen. A broker will have behind him a certain amount of his own capital and some deposits at notice made with him by his clients, but his chief resources are the money which he is able to borrow at call from the banks and finance houses. The broker buying from traders and selling to bankers makes his profit on the difference in rates, the bankers paying him $\frac{1}{8}$ to $\frac{1}{16}$ per cent per annum below the market rate. A broker will not handle documentary bills. The banker may either buy from the broker or lend to him. When he buys a bill outright he rediscounts it, and if a number of bills are rediscounted the broker usually does not endorse each bill but gives a guarantee to cover the whole parcel. If the banker is lending to the broker he may make the loan for a long fixed period on the security of bills deposited with him, or for a short fixed period, a week, or "from day to day" or even "overnight." The rate at which he lends is invariable during the fixed period, and, as a rule, the longer the period the higher the rate. Overnight money is often relatively high, because the borrower is generally willing to pay more for the sake of being

relieved from the necessity for borrowing from the Bank of England where the loan would be for a fixed period of days. The broker who expects to have ample funds within twenty-four hours can better afford a high rate overnight than a low rate over a period of from three to ten days. Brokers often deposit against money lent at call first-class bearer securities, like Exchequer bonds or Treasury bills. When the money is called by one bank, the broker must borrow from another, and these securities which drift thus from one bank to another are known in the market as "**floaters.**"

The overnight alternative, we have just seen, would be a loan from the Bank of England. No bank borrows money from the Bank of England, but calls its loans from the market when it is short of cash. If all the banks are thus calling in, the bill broker is left with no alternative but the Bank of England itself. He takes there his bills, which he either discounts at Bank rate or over, or deposits as collateral for his loan, which is made slightly above Bank rate. When dear money is anticipated, the broker naturally allows his portfolio of bills to empty itself, as the outstanding paper reaches maturity. When the broker is forced to the Bank of England the term applied is that he is "driven into the Bank." The market is "in the Bank."

§ 2

The money market rates are of various kinds, as we have noticed. The **Bank Rate** is the advertised minimum at which the Bank of England itself will discount approved bills of exchange of not more than three months' date or grant short loans. The rate charged to its own customers is lower than this advertised rate. It is **Market Rate**, the current discount rate on three months'

bank bills. **Call Rates** are the rates at which the market can borrow short money from the banks. **Deposit Rate** is the rate which the banks will pay for money lodged with them on deposit. Deposit Rate is by agreement two points below bank rate, except in the case of foreign banks.

It will be realized how close is the interaction of these rates. Market rate is below Bank rate, because otherwise the brokers would buy bills at will and rediscount them with the Bank, thus making an easy profit. Call rates fall between deposit and market rates because the Bank is making its profit on the margin between deposit rate, at which it gets money, and call rate, at which it lends, and the broker is making his profit on the margin between call rate at which he gets money, and market rate, at which he is able to use it.

All these rates are built upon the shifting sands of the gold position. I have by my elbow as I write a leading financial journal in which appears the following paragraph—

> "Apparently, the two leading continental banks of issue, the Bank of France and the Reichsbank, are engaged in a kind of financial 'armament race.' Both of them have been making heavy gold purchases during the last few months. While the former has acquired the greater part of its new gold by means of ear-marking operations in New York, the latter has attracted gold by encouraging its import through private arbitrage. The Bank of France is buying gold out of the surplus stock of the Federal Reserve Bank, and its operations are causing no inconvenience to anybody. In fact, the American currency authorities are probably pleased to see the gold go, as it assists them in checking the Wall Street boom by means of credit restrictions. The Reichsbank, on the other hand, is taking gold from London, whose stocks of the metal are not so large that a heavy efflux can be regarded indefinitely with equanimity."

Why should the efflux of gold to Germany cause the writer to lose his equanimity? The shipment of gold

means that the Bank of England has in place of the precious metal a cheque from the buyer. That cheque is drawn by the buyer, who is the actual exporter, on his own bank. When the cheque is collected the buyer's balance at the Bank of England falls by the value of the gold. In other words the item for "Other Deposits" has shrunk. The Bank of England, to effect the transaction, has paid from its banking department notes to the issue department and has received the gold. The notes item in the banking department and the notes and gold in the issue department both fall. The proportion has been altered. As the proportion falls the Bank's position weakens. It becomes necessary to check the export of gold.

Checking the Fall.

The fall in the proportion can be checked in two ways. The Bank can sell some of its securities. To buy these the banks will probably call in their loans. Call rates and market rates will rise. The rise in rates will make bills cheaper, and tempt foreign buyers, creating a demand for sterling in the foreign exchange markets. Or, by the other method, the Bank can recover its proportion by raising the Bank rate. When the Bank rate rises all the other inter-related rates rise also. Bills will be cheaper, foreign money will be attracted, traders at home having to pay more for borrowed money will lighten stocks, prices will fall, prices falling will attract foreign buyers, which will create a demand for sterling in the foreign exchange market, which in turn will raise the exchanges above gold point, and the efflux will be stopped.

In this process we have touched upon the relation which exists between the money market and trade in general. Goods are naturally attracted to the markets which are ruled by the highest prices and money to the

market where the interest rates are highest. Adverse exchanges are cured by bringing interest rates above the world level and the commodity price level below it. A loss of gold tends to do both of these things.

In the paragraph which we have just considered, the efflux of gold was not caused by the ordinary business of the foreign exchange market. Had it been so the market would have foreseen its coming. When an important exchange rate approaches the lower gold point the astute people on the market in London will reduce the purchase of bills and prepare for all the conditions of restricted credit following an efflux. As this causes higher rates of interest, the situation may hold its own cure, for foreign money may be quickly attracted to London and the efflux of gold prevented. A high rate will quickly attract gold, and the student may care to remember the old market tag that "7 per cent brings gold from the moon."

§ 3

The effect upon the money market of Government borrowing is of the first importance, but at this point I shall content myself with merely mentioning it, leaving an examination of the relationship of the State to the market to the later chapter which deals with national finance and finances. The intervention of a borrower of indubitable security and varying but considerable demands must alter the whole complexion of the market. We shall see later how and why the Government intervenes in the transactions of the money market, as it intervenes and affects the transactions of the stock market.

CHAPTER XI

CONTINENTAL EXCHANGES

A VOLUME which included a thorough survey of the present position of the continental exchanges and an examination of the history of foreign currencies between 1914 and the present date (1930) would far exceed the scope of this work, but it is essential that even the tyro in finance should have some conception of the abnormalities which were created by the War, the effects of which must continue to be felt for a generation to come. In Great Britain the currency system has in less than a decade and a half suffered four complete revolutions. In many European States financial catastrophe has been followed by a process of rehabilitation leaving the original system recognizable but different in both essentials and incidentals.

We will look first at the progress of British currency in Great Britain. From the passing of the Act of 1844 to the outbreak of War in 1914, currency was controlled by that Act with only three suspensions made in times of extreme crisis. The issue of notes for currency use was strictly confined to the fiduciary powers conferred on the Bank of England, the narrowing fiduciary powers of the country banks, and deposited gold. In addition to the stock of gold held by the Bank, varying from some £33,000,000 to some £38,000,000, there were smaller stocks held by other banks, and a vast amount of gold in circulation. The total metal in the possession of the nation was neither known with accuracy nor easily estimated. When war came, the authorization of Treasury

notes, issued and to be issued at the will and discretion of the department, created a new fiduciary issue. The export of gold was forbidden to private persons and closely controlled for others. The internal use of the metal to craftsmen was permitted, but as otherwise the desire for gold was regarded with suspicion and mistrust, the notes became practically inconvertible, remaining in theory exchangeable for the metal. No gold returns were made to the public, and the amount shown in the Bank return was not certified as being actually in the cellars of that institution. Much of it, many people shrewdly suspected, was held on behalf of the Bank in the Dominion capitals.

Pegging an Exchange.

Between 1916 and 1919 the exchange with New York was "pegged"—that is, the £1 was kept fixed at $4.76½, a process made possible by large loans in America and large sales of American securities held by British subjects. As the load of debt increased, this process was rendered increasingly inexpedient. In 1919, it was decided to abandon the American exchange to its fate, and to face the depreciation in sterling which would follow. As the first consequence would be an export of gold to the States, legislation was passed to forbid such export except under special licence. No longer could any person takes notes to the Bank, receive gold in exchange, and send it to a foreign creditor. This made effective the actual but unadmitted condition which had prevailed throughout the War, and marked the point at which this country actually and avowedly abandoned for a time the gold standard. At the same time the joint-stock banks handed for custody their stocks of gold to the Bank of England, acting as the representative of the Treasury.

The Bank was thus charged with the complete control of the total gold reserves of the nation.

During the War years the whole course of international trade had been changed. Some streams had been dammed, others had been diverted. Many commodities had been produced by great human exertions only to be fired into the air or the bodies of the combatants. Many producers and distributors had been taken from production and distribution to become for four years or more soldiers, sailors, or civilian non-productive units of the community. The needs of nations at war had caused prices to lose all relationship to normal values of exchange. The end of the War, with the knowledge in men's minds that the world was in desperate need of commodities, caused a sudden outburst of speculative production. Goods were produced and services organized to an extent which bore no proportion to the capacity of the impoverished peoples to pay for them. During the War years currencies had been inflated, partly by design and partly by the inevitable reactions from the conduct of mankind, which was often in the position of increasing its currency, that is the means of exchange, at a time when it was reducing or limiting its wealth, or the things to be exchanged. After the outburst of speculative production there came a reaction. The price of goods fell and fell abruptly. As the prices fell the amount of currency needed to purchase also fell. At the same time Great Britain was paying off external debt. The Treasury issue was accordingly restricted. We were, in short, deflating both prices and currency.

Too Rapid Deflation.

There can be little doubt now, being wise after the event, that the process of deflation was far too rapid for

the general immediate good of the community. As I endeavoured to demonstrate much earlier in this book, the effect of inflation is to attract orders for manufactures, and the effect of deflation is to repel such orders until such time as all currencies are normal. But what was temporarily bad for manufacturers was potentially good for all international traders. The unpegged American exchange dropped from $4.76½ to $3.21¾, but as deflation brought the British currency towards normal the American exchange began again to rise. It will be seen that with the exchange falling the £1 would buy less and less in America. With the exchange rising the £1 would buy more and more, with all the consequent reactions upon trade. In 1925 the nation was able to return to the gold standard and to remove the embargo on gold export. In 1928, as we have seen, the Treasury notes ceased to exist as fresh issues.

It should be noted in passing that by the amalgamation of the note issues in 1928 the Government abandoned a step which many currency experts had hailed with great approval. As no private enterprise has the right to coin metal money, so, it was held, no private enterprise should have the right to "coin" paper money. But against this has to be set the indubitable fact that since Government money is actually controlled by elected representatives of a political democracy, and since the experience of the War taught us all that a currency printing machine may be used by unskilled or unscrupulous hands to the grave disadvantage of the people, to entrust a note issue to politicians is very often to place more faith in political human nature than is justified in the event. The amalgamation was in some sense a guarantee against inflation for political motives. Inflation, I may remind you, means a polite form of spoliation, since

claims expressed in currency of a given value are satisfied by currency inflated in such a way that its value has decreased without the consent and often without the knowledge of the recipient. This is the reverse effect from that felt during a period of deflation when the money borrowed by the State or from some foreign lender is actually repaid in money of more actual exchange value than the amount of the debt it nominally settles.

European Currencies.

The steps which Great Britain took during the War to guard her own reserves of gold were not those taken by other belligerent nations. In Germany a series of laws and regulations was ready on 4th August, modelled on the experiences of 1870. The Reichsbank, partly by reason of these laws and partly by reason of the patriotism of the German citizens, who, like the English, surrendered all forms of gold, even treasured personal adornments, at the call of their country, was provided with a huge reserve. But by 1917 the foreign payments to neutrals had far exceeded in their potentiality reserves and inflow, and although at the end of 1918 the Reichsbank had a gold reserve of 2,262,000,000 marks, double the average for 1913, the German currency was of wildly inflated paper.

When the Austrian debacle was precipitated in October, 1918, the currency of the old Empire was of such depreciated value that the troops who crossed the Piave did not even consider it worth garnering from the line of route taken by the Austrian troops. It had become simply spoilt paper of no purchasing power. Even amongst the victorious nations currencies had suffered. The Italian lira, although it had been "supported," was suffering from extreme debility. (It will be understood

that a depreciated currency retains its nominal face values. Thus a lira is always a lira, even if it only buys this week one-half of what it bought last week. It is sometimes a little difficult to decide when depreciation is cause and when it is effect. Thus I was myself able to buy a hunting crop one day in Vicenza for seven lire, whereas a friend of mine riding in to purchase just such another three days afterwards was charged fourteen lire. The lire had not depreciated to that extent in any general sense, but the vendor had awakened to the fact that the rich and mad English were in the neighbourhood. On a hunting crop basis the currency had depreciated. On a metal basis it had not, for had the payment been made in gold the rise would have been the same, but prices had risen.) So it was to a greater or less degree with most, if not all, European currencies.

The Index Figure.

Depreciation has always this characteristic, however caused, that its virulence increases in a mad progression towards its later stages, for the lower the actual trading value of the note the more notes must be issued to pay for supplies, and the vicious circle swings its old familiar course, for the more notes issued the lower the value of each note. When gold export is prohibited it will be seen that the fall of the exchanges can continue almost indefinitely until the paper currency of the afflicted country is of no exchange value whatsoever. To what extent a currency is depreciated economists discover by means of an **Index Figure**, which is reached by drawing up a list of representative products and placing against each its average price for a selected base-year and its present price. Calling the base-year datum 100, the percentage change can thus be estimated, and the total

percentage change divided by the number of selected products gives the index number, which, let it be remembered, can only be approximate and selective.

During the years immediately following the War, the continental exchanges had lost all semblance of their pre-war positions. The neutral nations had retained a relatively stable currency, many of the allied States had suffered grotesque depreciation, but had managed to stem the tide. Most of the defeated belligerents had brought their currencies to complete collapse. All nations suffered from the fall in the purchasing power of gold.

Stabilization.

Depreciated national currency gave to manufacturers a command of foreign markets, but strangled import trade during the first phase. In the second phase the independability of native money caused a cessation of solid investment, a rise in prices and a demand for foreign currencies, with a wave of exchange speculation. In time the old currency, vast in quantity, proved hopelessly inadequate, bastard currencies appeared, and eventually a new official currency had to be created. This was the common experience of those States which had approached to within hailing distance of complete national catastrophe. The political disregard of financial principles, the failure to balance budgets, revealed itself as a fatal malady in the State, and after 1924 there was a general attempt to stabilize currencies and return to a gold basis, which, whatever its other limitations, does limit the financial folly of political jerrymanderers or currency gamblers. The League of Nations assisted such nations as Austria and Hungary to re-establish their currencies, the Dawes Scheme gave Germany the particular medicine her own malady demanded, and self-help

brought France and Belgium to/restored or returning fiscal health. A new par of exchange fixed by a new coin (the reichsmark, following the renten mark, worth one billion paper marks, is now at 20·43, as compared with the pre-war mark at 20·50¼) or by alteration of Mint regulations to standardize a different content value to the older coin (the franc now at 124·21 as against 25·2215 pre-war) was the chief measure of such restorations.

The Consortium.

The experience of the War years included not only the British experiment with the pegged dollar rate, but also a demonstration of the " consortium " system of exchange control. The study of this system is essential to specialists in foreign exchange practice, but here it will be sufficient to explain that as outlined by Luzzatti, the Italian economist, the method rests upon the idea that as a country's exports provide her with claims upon the currencies of her customers, and her imports give claims to foreigners upon her own currency, whenever a state of equal claims is reached the banks can be forced into a consortium and compelled to sell to the State all claims on foreign currencies derived from exports, and to ration this exchange for the purpose of paying for imports. Greece embodied the system into the GxmB Law of 1883, and a National Institute for Foreign Exchanges was inaugurated in Italy by Signor Nitti in 1917. In practice the system operates as a virtual control of the trade balance and has the virtue of reducing currency speculation. But, as Dr. Shaw rightly points out, " there are three fundamental flaws or weaknesses in the system : (1) The official side of the consortium committee looked mainly to the accumulation of a stock of foreign exchange for the supply of Government needs. This leads to

favouritism and injustice to the trader. (2) Although the banks themselves proved consistently loyal in their co-operation, the trader could not be prevented from evading the control. (3) Government control of paper currency issues remained unrelated to all such consortium or Institute schemes. This is, of course, the crucial and most fatal defect, for while the consortium aims primarily at supporting the exchange any uncovered issue of paper acts as a depreciator." (*Currency, Credit, and the Exchanges*, by Dr. William Shaw.)

The great justification for the resort to the consortium system by several European States was the necessity for checking the wild fever of speculation which the War and the post-war conditions bred. The system in practice failed to achieve any other valuable object, and with the return of the nations to the gold standard it has ceased to be a desirable alternative to the normal practice of the exchange markets.

Experts' Report.

Those who, from the elementary discussions of this book, pursue further the study of the foreign exchanges, will find that the political questions of international debt payments and reparations remain, and must remain for some time to come, the two dominating factors in the post-war exchange problem. A study of the Dawes Report (more accurately called the Experts' Report) of 1924, and of the Young Plan and its child, the "Bank for International Settlements" (see page 129) is essential to a thorough understanding of the present position. There is the alternative before the nations of either accepting German goods or relinquishing reparations. Germany's habit of paying reparations not out of trade surplus but by the raising of loans, carrying interest

obligations which increase the need for foreign exchange has already complicated the world situation. To what extent the International Bank will solve the complex, time alone can tell. Upon its success or failure to fulfil its widest function the future of the continental exchanges will turn.

It will be realized that, desirable as is the restoration of collapsed currencies, the process of stabilizing the exchanges must react upon trade. Just as the depreciation of a currency benefits for a time the manufacturers of the country concerned, so the restoration must tend to reverse the process. Considered as deflation a restoration of currency has been the object in this country of very bitter attack, but it has, at worst, the qualities of its defects. It lowers the internal prices of imported goods, which means a cheaper rate of living costs, and it increases the credit power behind foreign trade. But whatever its effects, whatever the point of view of its critics, it is essential to remember that a criticism of the process of deflation and of currency stabilization is not a criticism of the condition attained by that process. The regimen which the physicians prescribe to a patient may be exceedingly unpleasant, and may actually for a time seem to lower his vitality, but it would be folly to maintain that a state of normal health is itself undesirable merely because the process of recovery involves pains and aches from which the invalid revolts.

CHAPTER XII

THE EASTERN EXCHANGES

DURING a discussion on bimetallism which occupied a previous chapter, reference was made to the difficulties which arise in the dealings of a gold standard country with nations using a silver standard. We saw that silver coinage in this country is legal tender only for a very limited amount (40s.) and that there is no right of free coinage. Silver in this country is only a market commodity which happens to be used in the token coinage issued for the payment of small amounts. The value of silver in a shilling or a half-crown is in no way related to the nominal value of those coins. If, therefore, an Eastern coin of fixed silver content is brought to this country, it has no relative silver coin here with which it may be compared, nor can an English shilling be taken East and compared by content with the native currency. In some countries, in Europe and America, there exists a double standard under which, without the open mint for both metals, there is a legal right to discharge liabilities in either at a fixed ratio, but in practice a double standard country is a gold standard country, and the especial difficulties of the East do not arise. In the exchanges on Mexico, Alexandria, Constantinople, Shanghai, Hong-Kong, and Singapore, silver is the standard, and in India we have a silver currency based on gold.

The Eastern exchanges—excluding India, which has special conditions—react to all the influences which affect the movement of Western exchange rates, but they are complicated by the variation in the price of silver.

With the exception of Japan, where the *yen* is on a gold basis, these exchanges lack both a par of exchange and a gold point. It is the price of silver as a commodity plus the costs of transit which determines the levels above and below which Eastern exchanges will not rise or fall. The immediate effect of a rise in the commodity value of silver has often been demonstrated, and shows itself in odd ways, as when in 1919 and 1920 the shares of the Deutsch-Asiatische Bank suddenly appreciated, merely because the steady rise of silver through 64d. to 89½d. per ounce had augmented the value of the bank's holdings in the two countries, China and Japan, where the bank operated.

The Indian Exchange.

The history of the Indian exchange, from the abandonment of the double standard in 1835 to the report of the Hilton Young Committee of three years ago, is a fascinating study. It cannot be pursued here, save in the barest outline. In 1835 the silver rupee became the only coin of legal tender, the gold coins becoming token coinage. The rupee contained 165 gr. of fine silver against the 444 gr. fine of the standard ounce. This gave us a par of $\frac{165}{444}$ of the price per ounce of standard silver, which obviously varied day by day as the metal fluctuated on the market. The rupee exchange was for many years normally against us, India selling more commodities than she bought and having an ample margin after the payment of all governmental costs and obligations. The exchange value of the rupee was thus usually above its intrinsic value. The expenditure of India involves considerable payments in England, which were made good by selling bills here drawn on the Indian Treasuries. These council drafts were paid in India in

rupees, and were bought here by traders who used them for payments in India and thus escaped the necessity for shipping silver. The larger the quantity of these drafts on sale, the lower the price of silver, owing to the less demand, and the lower in consequence the Indian exchange.

Between, roughly speaking, 1870 and 1890, the rupee exchange was the sport of political and currency battles in the United States and South America, where the fight over bimetallism waged furiously for several decades, and the price of silver was affected. After the early days of the nineties some progress was made towards the ultimate goal of relieving the rupee from its absolute dependence upon silver commodity prices. For reasons of political expediency and to preserve the confidence of the native user in his currency the silver rupee had to remain the standard coin. It was, however, eventually pegged at the rate of 1s. 4d. per rupee by a series of steps, including the withdrawal of the right to tender silver for coinage into rupees; the readiness of the Secretary of State to sell council drafts to any quantity at the maximum rate of 1s. $4\frac{1}{8}$d. per rupee, with a practice not officially imposed of not selling below 1s. $3\frac{29}{32}$d.; the making of the sovereign and half sovereign legal tender at 15 and $7\frac{1}{2}$ rupees; and the guarantee that a temporary Indian adverse trade balance would be countered by selling reverse council drafts on London by the Secretary of State whenever the rate fell below 1s. $3\frac{29}{32}$d. In effect, the position was established that whenever trade demands took or threatened to take the rupee to 1s. 5d. or over, the sale of rupees in the shape of council drafts brought it back to 1s. 4d., and any fall or menace of fall to 1s. 3d. was met by the sale of sterling by the Secretary of State. This system gave to the Government a certain control over Indian finance, and persisted until the outbreak of War.

After the War.

The reactions of the War on India and Indian exchange were many and drastic. Goods were in demand by all the allied nations, imports were no longer freely purchasable, the men fighting in the Eastern "side-shows" were drawing rupees, and everything tended to increase the favourable trade balance of the Dependency, and to expand the demand for rupees. While the demand for currency increased, the supply decreased. The provision of rupee notes without backing was a danger particularly to be avoided, and it became necessary in 1916 and 1917 to ration the supply of council drafts, against which rupees could not be had, and to increase their price *pari passu* with the rising price of silver, which in 1917 touched over 43d. per ounce. In the December of 1919, a year after the cessation of hostilities, the rupee rate went to 2s. 4d., imported gold was diverted to the Government, and the private importation of silver was forbidden. Even so, the stock of silver was inadequate, until the shipment of 200,000,000 fine ounces from America, under the provisions of the Pittman Act which had passed Congress in Washington after negotiations between the United States and Great Britain, brought some respite. But the old system was patently impossible under the post-war conditions. At the end of 1919 a committee, under the chairmanship of Sir Henry Babington Smith, reported and recommended various changes. For reasons which need not here detain us their recommendations were not effective, and in 1926 the Hilton Young Committee presented another report, which recommended the formal adoption of the gold standard for India with the establishment of a Central Bank. In 1927 the first portion of the report was made effective by legislation. The Act lays down that the rupee be stabilized at a rate of 1s. 6d.

gold, or 1 rupee for 8·47512 gr. The sovereign and half sovereign were demonetized, being no longer legal tender, but exchangeable only into bullion value. Until the Central Bank is established the Government of India must, by the Act, buy and sell gold or gold exchange at gold-points fixed by the parity of 1s. 6d., dealings to be in quantities not less than 1·065 tolas.

Whether, when the Central Bank is established, and the new system working properly, the old troubles arising from virtual bimetallic conditions will be eliminated, is still argued. Dr. Shaw maintains that the weakness of the Hilton Young recommendations is that they fail to eliminate those troubles, that they do not solve the bimetallic problem. To his mind it is only by the relegation of the rupee to the status of token money and by limiting its legal tender that the danger of bimetallic action can be avoided.

> "If the rupee is continued as legal tender currency, then 15 silver rupees can command one pound sterling, and 500 times 15 rupees could claim to be converted into £500 worth of gold bullion. It is this bimetallic action which broke down the gold exchange standard in 1920, and it will similarly break down any and every system that the art of man can devise which attempts to link the two metals together. This is not a matter of opinion. It is the verdict of history, and there is no going back on it."

Outside this point there is, as far as I know, no criticism raised against the Hilton Young scheme, and given this vital change even its critics see in it the promise of a workable and efficient system of currency and exchange.

§ 2

Before leaving the foreign exchanges we may, with some advantage, examine briefly the Anglo-Egyptian exchange which has appealed to many critics of the

classical theory of the exchanges as offering a demonstration of a system of exchange which offers an equilibrium by mechanical means. From the year 1885, the year of the London Convention, Egypt had a metallic currency on a gold standard, with token money of silver and a small circulation of notes issued by the National Bank of Egypt. The Egyptian currency thus moved with the gold movements of the world, and with the £1 at 97·5 piastres the gold points were at 97 and 98. Dr. Shaw has estimated the total effective circulation of the country at some £25,000,000 sterling of gold (mostly in the form of British sovereigns and French 20-fr. pieces) plus 2,500,000 Egyptian gold pounds. The note circulation, which was at £140,000 at the beginning of this century, rose to £2,700,000 in 1913, the last normal pre-war year. Egypt's export commodity was cotton, and the cotton crop was financed by the import of gold, which was subsequently re-exported to finance the Egyptian imports of other commodities. There was thus an almost regular movement of gold imports and gold exports.

London and Cairo.

The War made this system of financing impossible, since gold could not be imported. The notes of the National Bank of Egypt, with a reserve against issue half of gold and half of securities were proclaimed *cours forcé*. The securities behind half the note issue were both Egyptian and British Government securities, and it was quickly realized that if the British securities were deposited in London they would serve as cover for credit advances, such as note issues in Egypt for the financing of cotton. The deposit in London was accepted as cover for an issue of Egyptian currency in Cairo, it being agreed by the Government and the Bank that such issue should

be made at par. This obviated the need for gold import and export, since all that was necessary was to deposit British securities in London instead of moving actual funds. The Egyptian note issue was augmented at Cairo, and in London the cover account of securities rose accordingly during one operation—the financing of the crop—and during the second operation the securities were released to their proprietors and the notes returned to the National Bank of Egypt.

Egyptian credit was thus organized by the alternate expansion and contraction of the note issue, rendered automatic by the needs of the country. The issue might be double its minimum at maximum, or might rise only some 40 or 50 per cent on its minimum, but it expanded or contracted without conscious control by either the Government or the bank. Once the effect of the system was grasped the regulation which laid down a half cover of gold for the issue was relaxed (1916), and the effectual cover for Egyptian notes became British securities deposited in London. Since under this system either capital will issue notes against securities deposited in the other, to any extent, the London-Cairo exchange for as long as the system is operated must remain at par, and being at par this rate naturally affects quotations for bank drafts, which will vary from par only by the brokerage commission and the cost of transport of currency from the point of issue.

It has been widely held that wherever there is an Imperial attachment between two centres of exchange, and where a note issue is the legal tender of both centres, such an automatic regulation of credit could be applied, and the common fluctuations of exchange eliminated. Since it is not to the purpose of this book to embark the reader upon any controversial voyage, much less to

advocate or oppose any contested theory of exchanges, I must leave the study of the Egyptian exchange at this point, contenting myself with this word of warning, that Egypt, whether in the days when Pliny wandered the banks of the Nile with his tablets, when Cromer and Milner undertook its reconstitution, or when currency experts began to draw from its war-time financial history in our own day a series of new inspirations, has always been unique in its trading and credit conditions. The simple mechanism of the Egyptian experiment might not function so efficiently between States whose trade cycle was not activated solely by the annual requirements of a single staple export.

CHAPTER XIII

THE PRACTICE OF FINANCE

THE reader of this book whose personal interest in finance is confined to the investment of his own money in enterprises which shall yield him a good and safe return, or to whom the machinery of the foreign exchanges and the theory of money are alike tediums to be endured rather than fascinations to be enjoyed, may feel that in this and succeeding chapters he has "a suit that touches Caesar nearer." None the less, the appreciation of the effects of money movements caused by the operations upon the money market, either of the Government or of foreign exchange dealers, will be found to have a direct bearing on the investments of the ordinary person, whose own money never amounts to sums of any great magnitude. There are, it is true, many men abroad in the land who seem to possess an instinct, a sixth sense, for investment without any real knowledge of financial theory and very little acquaintance with financial practice. Conversely, the cobbler's children are proverbially the worst shod, and very often the financial expert and the city editor advise on the investments of others better than they seem to advise themselves on their own. However limited the mental range of Mr. Humbert Wolfe's financier, many a city man must have felt about investors what Browning's Sludge felt about his two farmers when he assured his patron—

. . . Oh, be sure,
You, everybody, blunders, just as I,
In simpler things than these by far : For see :

I knew two farmers—one, a wiseacre
Who studied seasons, rummaged almanacs,
Quoted the dew-point, registered the frost,
And then declared, for outcome of his pains,
Next summer must be dampish : 'twas a drought.
His neighbour prophesied such drought would fall,
Saved hay and corn, made cent per cent thereby,
And proved a sage indeed : how came his lore ?
Because one brindled heifer, late in March,
Stiffened her tail of evenings, and somehow
He got into his head that drought was meant !
I don't expect all men can do as much :
Such kissing goes by favour. You must take
A certain turn of mind for this—a twist
I' the flesh as well . . .

But, lacking this turn of mind and twist of flesh, the normal person may confidently feel that by studying seasons, rummaging almanacs, quoting the gold points, and registering the financial frosts, he may hope, at least, to be wiser in the disposition of his own possessions.

§ 2

The desirable thing in the study of financial practice is to forget for a while the definitions of **capital** which have been framed by the economists and to agree with Mr. Bernard Shaw that **capital is money.** Let us hasten to admit to our examiners, if we have still to confront them, that "capital is wealth of any kind saved and used for productive purposes," or that "capital is the embodied power to wait," that it may take the form of tools, instruments, plant, goods, raw materials, products in store at warehouse or shop, and the buildings in which these things are made or stored; but for our immediate purpose let us agree that when we talk about capital we mean the money which commands these things, and not the things themselves.

Use of Capital.

Capital, in the economists' sense, obviously performs several very vital functions. It gives to mankind his mastery over matter and over time. Without capital every individual member of society would be compelled by the needs of self-preservation to spend his energies in satisfying, by primitive pursuits, such as hunting, fishing, or the tilling of the ground, the physical demands of each moment, and even so would need the capital of his body to enable him to hunt, fish or scrabble the earth. Capital, in our immediate usage of the word, enables the entrepreneur to obtain those material things and those human services which are necessary to the foundation and pursuit of his business. He must have factories, machines, raw material, books, premises, middlemen who themselves need similar possessions, and workers who cannot wait for their rewards until the produce of their labour has been exchanged for that of other men's labour. He needs also men who will discover markets for his produce before he actually produces, or, conversely, men who will undertake to sell the produce already produced in markets wherein the buyers may not be capable of offering an immediate exchange, traders, that is to say, who want credit.

There is one way and one way only by which a community can accumulate capital in the economists' sense of the word, and that is by its members consuming less than they produce or than Nature offers to them. In a later chapter we shall discuss the various economic, political, and financial reactions of public and private thrift. At the moment we need register only the simple fact that capital accumulates only when production is greater than consumption. In a modern community all production and all remuneration for services take shape

in terms of money. If industry can obtain command of money, it can itself transform that money into economists' capital. How, then, does industry secure its capital? How is it financed?

The Simplest Way.

When my friend John Doe discovered, that by using some of his own savings and some of my savings to buy wood and employ a carpenter, he could produce an article which would sell at a profit (see Chapter IV) he financed his enterprise in the simplest possible way, by applying his own savings as far as they sufficed and then by applying my savings, for the use of which he gave to me a share of his profit. The draper's assistant who, by frugal living in youth, manages to scrape enough money to set himself up in a small shop, as has been the case with many representative figures of our time, has applied just such simple means. But many a draper's assistant might accumulate some little money without wishing to begin business on his own account, and many a draper's assistant might wish to begin business on his own account without having accumulated sufficient, if any, money. In such cases a combination of one man's savings and another man's services might produce an enterprise conducted by an active and a "sleeping" partner, just as the combined efforts of two such partners both contributing some capital and some effort would give us a partnership with two active participants.

Similarly, a man, having founded a successful business and finding himself unable to provide sufficient capital for its expanding needs, might secure from his bank funds with which to conduct it. Since, as we know, the funds provided *by* the bank have been provided *to* the bank by individual citizens, we then have an unacknowledged

partnership between the man and a variety of persons whose means he is using, but to whom he has no direct responsibility, and who rely for the return of their means when wanted not upon him but upon the intervening organization.

Direct Responsibility.

In Chapter VI we laid it down that it is not the function of a bank to provide fixed capital for its customers, but that such capital should be provided either by the entrepreneur himself, by a partner brought in for the purpose, or by the public. From the viewpoint of the entrepreneur, what the bank really says when it refuses an overdraft with the suggestion that new outside capital should be brought in is that the responsibility of the user of the capital to those who supply it should become a direct responsibility and should cease to be indirect with the bank as an intervening bearer of risk.

If the man who needs capital derives it from others who know him personally, and who are prepared to join in his enterprise either as active or sleeping partners, the resultant firm remains the genuine type of a private enterprise, in which the providers of capital, the engagers of labour, and the directors of management are the same.

But such firms could never have exploited the wealth of the world as it has been exploited, nor could groups of individual citizens known to each other have secured the use of an adequate accumulation of capital for the purpose of creating and satisfying civilized needs as we know them. Without wandering through the mazes of economic history, let us assume that the realization of the use of, and need for, wider bodies of co-operating entrepreneurs transformed by easy stages, and without a

conscious breach with tradition, the primitive reliance upon individual effort or simple partnership into the beginnings of modern industrial organization. Guilds, companies of gentlemen adventurers, joint-stock companies, early corporations, all developed and flourished by activities which could never have attracted or held the individual entrepreneur because of the outlay involved or the necessity for delay between such outlay and the eventual return from it. Such enterprises had an obvious advantage over personal enterprise in that they remained active as trading entities for periods longer than the span of a single working life, or the working life of a normal partnership.

Limited Liability.

Such joint enterprises, attracting capital from many sources, retained for many years of our history the defect that their participants were not only jointly but severally liable to the full extent of their possessions for the debts of the enterprise. This repelled capital that would otherwise have been attracted. When in 1878 the City of Glasgow Bank failed, every shareholder had to give up his or her personal possessions to meet the demands of the depositors, and many private citizens who held, or whose trustees held, shares in the bank found that they were ruined thereby, even though they might not even have been aware as beneficiaries under a trust that any of their fortune was so laid out. Whenever such an example of possible ruin from participation in a joint enterprise was thrust upon the attention of those with small amounts of capital at their disposal, there was for some time after a very natural unreadiness to adventure savings. But twenty years before the Glasgow bank failure there had been incorporated in our company law the principle of

limited liability, by which the responsibility of any contributor of capital was limited by the amount of capital contributed. If an individual shareholder had a share in the enterprise represented by £100 and the enterprise failed, he lost his £100, but no more than that.

The limited liability company is the commonest means to-day of financing industry. Such a company offers to all who will permit the application of their private capital to its enterprise, freedom from an unknown and ungaugeable risk, with some certainty of return, and often, as we shall later see, with the guarantee of a fixed and known return to the extent of the company's assets.

Industry is financed by other methods, some of which the limited liability company itself employs, such as the return to capital use of profits made. Co-operative associations are financed by consumers, who receive the profits which they make in their capacity as capital suppliers. Municipal and State enterprise is financed by a forced levy upon the community used as security for money borrowed from the public. (It is, for example, a fallacy to regard the ratepayers as the capitalizers of the tramways of a city, or even, to some minds, as the actual owners. It is not the rates which provide the capital used, but the municipal loans, secured as to interest by the rates.)

The Use of Advertisement.

The modern method by which capital is obtained for financing an enterprise can be defined in one familiar word—advertisement. When populations were smaller and enterprises less extensive in their scope, which meant that those who launched and were to conduct the venture asking for capital were known to those from whom the

capital was asked, advertisement was still the means employed, but it was the primitive advertisement of making known the proposals and the potential profit by word of mouth or some simple form of communication. To-day, when necessary, capital has to be collected from a variety of persons scattered as to residence and having no real touch with the people who will control the money they subscribe, the advertisement of the project takes a more complicated but more formal shape. The merits of the proposed enterprise and the descriptions of those who will control it are set forth and published abroad in the land. This setting forth of the prospects before those who participate in the venture gives us the document known as a **prospectus**, of which we shall have more to say later. But since advertisement can attract only potential subscribers to the venture, and since those potential subscribers need some easy means either of remitting their share of the capital or of signifying their readiness to participate, and since, also, there may not offer sufficient private subscribers of capital to satisfy the needs of the company, there has evolved a machine whereby all difficulties are met and all associations rendered easy.

This machine has many detached parts. There are the specialized dealers in capital, the financiers who have capital of their own to employ and who have the management of capital supplied by others, and who can, by their knowledge and manipulation of the money market—in the broadest sense of the term—borrow and lend money in such ways that each part of the dual transaction shows a profit to themselves. There are the banks, the stock and share brokers, and the lawyers, whose general functions include the particular function of directing available capital into whatever channels may commend themselves to their judgment. There are the great

investment and trust companies, growing each year a more powerful factor in finance, which, again speaking broadly, take control of the money of a variety of unskilled investors and apply it with the knowledge and skill of men whose chief study is that of the profitable employment of funds.

Underwriters.

When a project and its needs for capital are advertised to the public, there is always the probability, which I have mentioned above, that there will not be a sufficient amount of capital forthcoming from individual subscribers. This probability is insured against by the employment of **underwriters.**

Underwriters are persons who, when an issue of shares is made by a company, agree to take either a certain number of those shares or the amount not taken by the public, and this they do for a commission. Thus, if the public eagerly applies for shares, the underwriters receive their commission merely for standing-by to shoulder a responsibility which never eventuates. If, on the other hand, the public displays a reluctance to subscribe capital to the particular enterprise, the underwriters may be left with a heavy burden of shares.

It should be borne in mind that the Stock Exchange, whose functions we are later to examine, does not play any part in the provision of capital for businesses. Before stocks and shares are dealt in on the Exchange the capital must have been provided, at least in part.

It should also be borne in mind that the capital of different companies is provided in different ways and from different sources. One enterprise may derive all its capital from a few wealthy persons. Another may derive its capital from a multitude of relatively poor people.

Another may have found some of its capital from a few wealthy persons, and some from a scattered constituency of relatively poor persons. Another may have procured its capital from some other and older company, or from some enterprise whose place it has taken. But, however the capital is found, it is, in the last resort, the savings of the community. It is, in an old army phrase, "the unconsumed portion of the day's rations." Those who possess the unconsumed portion, and apply it, may or may not have a moral right to it by this or that school of ethical teaching. The unconsumed portion according to the doctrines of this or that school of sociologists might have been better employed had it been consumed by those going hungry. These things, for the moment, are beside the point—which is that all capital is the fruit of saving, or, to phrase it differently, is the result of somebody's sacrifice of present enjoyment for the sake of future gain. From the viewpoint of the community, therefore, it does not matter from what sources capital is derived, or by what manoeuvres it was accumulated by those providing it, but it does matter that it should be properly administered. And by the proper administration of capital I mean, in this context, its application, with economy, to purposes which promise—even if, after experiment, they do not achieve—increase of wealth to the community. The justification of the financier is that he diverts capital from less to more profitable uses. Whether the increased profit finds its way to the right pocket, is a matter for the social reformer, or for the individual conscience of the financier.

§ 3

When the possessor of some amount of money surplus to the sum required to satisfy his or her immediate needs

decides to apply that amount as capital, we speak of the money as being invested. By the sanction of usage **investment** has come to mean the application of money to some enterprise which by its own economic progress—its success in the industry or business with which it concerns itself—will earn such profits as to enable the providers of its capital to take from it a relatively safe return in interest. If I visit my rich aunt and flatter the old lady so successfully that she presents me with a cheque for £100 at the end of my stay, and I take that sum and place it at the disposal of a new company in whose progress I have confidence, meaning to leave my money with the enterprise during that progress, I invest my money with the firm. But if, knowing little about the company and hearing from a friend that its shares are likely to rise, I take 100 £1 shares in it, hoping to sell at a profit within a few days, I have not invested my money with the firm. I have merely speculated £100 on the chance of a rise in its shares. (See " Stags," in Chapter XV.) I may, it is true, have provided, from the viewpoint of the company, some of its initial capital, but only for such time as was required for me to find another person with a surplus to provide me with an equivalent sum plus a profit for the advantage of having £100 worth of capital with the company. Again, if I had no real faith in the progress of the company, but imagined that there was a sporting chance that it might make big profits, I might at one and the same time invest my money in the project and **speculate** the sum on the chance of a big return. I labour this simple point because many people appear to confuse investment with the mere intention to allow the money handed over to a company to remain for a long or an indefinite period with that company, and to confuse speculation with the

intention to turn money over quickly at a profit. The investor can invest for a short as well as for a long term period. The speculator may speculate on distant as well as on immediate profits from the risk he takes. And both investor and speculator may equally fulfil the function of providing genuine capital.

The converse of that last sentence is also true. The investor does not always provide capital for the company any more than the speculator fails always to provide capital. If, after the establishment of an enterprise, I invest my money in it, I do so only by taking the place of someone who originally provided the capital, the ownership of which I then assume. The investor has thus often no more claim on the gratitude of industry than the speculator. The investor cannot, therefore, plume himself that he provides industry with its capital, while his speculative brother merely juggles with financial counters. It is the increase to the total of new capital upon which industry may draw which matters; and this increase comes from both the speculators and the genuine investors.

Sound Investment.

Looking at investment and speculation from the viewpoint neither of industry nor the community, but of the investor or speculator, what characterizes, in practical life, the sound investment? The characteristics of a good investment are three—there is the security of the money invested, there is the security and adequacy of the return from that money, and there is the probability that the capital provided will be worth more in the future than in the present. In theory no money is secure. The best enterprise may, from obscure and unexpected reasons, come to grief. Governments may fall; nations,

by natural or political catastrophe, may perish; commodities once attractive to consumers may cease to attract or be supplanted by some substitute created by some new invention or unforeseen exercise of human ingenuity. In theory, I say, no money is secure, but in practice there are degrees of security which include a virtual safety. Some enterprises are so extremely unlikely to come to grief, and have such extensive saleable assets that their coming to grief as trading concerns would not necessarily ruin their shareholders, that the risk to the money invested in them is negligible. Certain governments are so extremely unlikely to fall in other than a party sense and some nations so extremely unlikely to perish, that money entrusted to them is virtually safe. Some enterprises are filling so stable a need and are being so ably conducted, that their capital cannot fail to yield a good and adequate return, and are financed so wisely that their capital must appreciate—that is, their assets on dissolution will command more than was laid out upon them originally. Where these characteristics are found, there the possessor of surplus money may assure himself that he has found a sound investment. Where one or more of these characteristics is lacking, the investment becomes speculative. Where there is neither apparent security for the money invested, nor firm assurance that the promised return will in the event be forthcoming, and where, in addition, the original capital of the concern may depreciate instead of appreciating, there the possessor of surplus money will know that he is faced by a pure speculation, by a risk that he may lose his money which he chooses to take, as a gamble, in the hope that he will increase it far beyond the augmentation which would be effected by the process of accumulation from a sound investment.

Adventure Not Blameworthy.

A company formed to convey passengers from one island to another, with the assurance of the steady patronage of a known body of islanders, might be able to pay interest on capital only to the extent of 4 or 5 per cent. A company formed to convey a party of adventurers to the South Seas to dig up the buried treasure of some seventeenth century pirate might, if the treasure were found, recoup the capital providers many thousand-fold, and, if the treasure were not found, pay them nothing, since even the concrete assets first purchased might have been consumed, destroyed, or pledged.

It is, again, desirable to avoid any Pecksniffian attitude on these matters. It is as well that some adventurous souls should send out expeditions to discover the treasures of Captain Kidd as that more cautious persons should apply their money to the provision of ferry facilities for the islanders. To propose the extraction of gold from sea-water may be foolish, but it is not necessarily blameworthy, since at one time the proposal to extract a curative element from tar would have seemed equally absurd. But the small investor has only himself to blame if he mistakes for a sound investment what is palpably a speculation, or expects from some humdrum, but safe enterprise the return which might by very lucky chance come from some wild and adventurous excursion into realms where untapped wealth was supposed by an optimistic dreamer to lurk. He has only himself to blame if he allows the plausibility of such optimistic dreamers, or of cynical rogues, to persuade him that an enterprise embarked upon to exploit a possibility is as safe as an enterprise embarked upon to derive profit in moderate but just amounts from the business of satisfying a normal want expressed, or likely to be expressed by society.

CHAPTER XIV

STOCKS AND SHARES

We have seen that, still broadly speaking, an industrial or commercial enterprise obtains its capital by allowing a number of persons with surplus money to take shares in its ventures. By an easy and inevitable transition the word "share" in this connection has come to mean in ordinary parlance the document which signifies the possession of a right to a certain amount of the capital of the company, and all rights of interest pertaining thereto, but we shall do no harm to our clarity of thought if we remember that a share is quite literally a share in the actual enterprise, and not merely a piece of paper which can be bought and sold as a detached money "counter."

If an enterprise gathers capital to the amount of £1,000,000, and I provide one of those £1, I have a right to one-millionth of its capital if ever the enterprise is abandoned and the company is dissolved. In a simple and ideal world the value which any buyer of my share would attach to it would be an index of the prosperity of the company, judged by the increasing value of its assets and prospects. Our own world being neither simple nor ideal, the value of my share in an actual company is often affected by quite other considerations; but unless the simpler and obvious relation between my share with its fluctuating value and the enterprise with its forward or retrograde progress to or from prosperity is grasped, the later complications will never be understood nor their significance appreciated.

Stocks, Shares, and Bonds.

The financial tyro who surveys with awakening interest either the financial columns of his newspaper or the activities of his fellows, finds much to confuse him in the buying and selling of the capital rights in the various enterprises in which the public has participated. He will find, first, that the securities which represent those rights are of two main classes—**Stocks** and **Shares.** He will also find a third category, known as **Bonds.** The capital of a company, as we have seen, is the money contributed by its members, and forms the stock. The very name, joint-stock company, implies a company whose stock is jointly supplied, and jointly held. If ten members contribute £1,000 each to a company they may either hold so much stock or so many shares, having £1,000 of stock, or 1,000 £1 shares, or ten £100 shares, or 20,000 1s. shares, and so on. That is entirely a matter of original organization. But, as we shall see later, once the decision is made, much turns on it. The methods of holding and transferring stock differ from those of holding or transferring shares. But before examining the characteristics of stocks and shares in detail we may look with advantage at the means by which both are created.

If we consider the needs of any body of men joined together for the pursuit of some activity, we shall see that, no matter whether they form a commercial company or a government or a philanthropic organization, they must first have money with which to inaugurate their enterprise, and may at varying times need more money either to allow them to tide over a bad period or to extend their activities. They may obviously find money in two ways, by soliciting the use of the capital which private persons have available or by borrowing. If they borrow,

they may have to continue the process, borrowing a second time to satisfy the first lender, and a third time to satisfy the second lender, and so on. They may borrow, as we have seen in earlier chapters, from a bank, which will demand certain types of security, or they may borrow from the public.

Loans.

Of the associations which make a practice of borrowing, governments, municipalities, and other public bodies are the chief, and joint-stock companies the next in importance. No Government and no municipality solicits capital in the ordinary sense for its activities; it invites loans. It will be quite clear that the private person with money to lay out to his advantage can thus supply either capital or a loan, and, since by usage we have allowed the words to serve a double function, in providing either he is said to buy either the capital or the debt. If I buy a portion of the Government debt or the debt of some industrial undertaking, I become legally a creditor, with all a creditor's rights. If I buy capital, that is if I take shares in a company, I become not a creditor but a proprietor. The daily traffic in stocks and shares thus involves constant transfers of ownership and of creditorship. When we examine the various kinds of security we shall find that it makes an enormous difference to the private investor which he buys, capital or debt. For the moment it is only necessary to note the distinction in passing.

Mr. Hartley Withers in his little classic on *Stocks and Shares* has ably summarized the evolution of public debts. From the ancient practice of using force of arms and internal despotism to keep the public coffers well stocked with treasure to the modern habit of assuming that debt

is an essential of good government the way has been long and full of incident.

> "The change," writes Mr. Withers, "arose gradually and imperceptibly. In the Middle Ages kings seem to have alternated between the possession of hoarded resources and chronic indebtedness, according to the circumstances of their reigns and the bent of their own temperaments. Thrifty monarchs who did not happen to be engaged in ruinous wars acquired assets. Expensive ones with a taste for display, a band of rapacious favourites or a thirst for military glory, acquired liabilities. If these liabilities became too pressing and could not be met by the comparatively respectable methods of debasing the currency or forced grants, there was nothing for it but repudiation . . . Richard Coeur de Lion, the kingly knight-errant who vied with Saladin in chivalry, went further even than repudiating debt. He sold certain assets of the Crown, and subsequently took them back again, on the ground that he had no right to alienate them . . . Foreign monarchs broke faith with their creditors even more readily and often than the English sovereigns. Taine records that French debts were dishonoured no less than fifty-six times between the time of Henry IV and the Revolution."

Interesting as may be the financial vagaries of the mediaeval monarchs, they are not so interesting to us at this moment as the enterprise of Charles II, whose merriness led him to filch from the exchequer £1,328,526, deposited there by our friends the London goldsmiths. Rogers in his *The First Nine Years of the Bank of England*, records that of this sum half was acknowledged by Parliament as a national obligation and forms, in origin at least, the oldest part of the public debt, though it was not formally recognized till 1701.

The National Debt.

The national debt, of which the transaction of Charles formed the oldest part, may really be said to affect public finance from 1793 onwards. It was in that year that Pitt, submitting to the demand for war with the

revolutionary government of France, changed the whole face of political finance. Pitt's regime as a finance Minister will concern us later, when national political finance is studied, but it is vital to note that whereas the debt in January, 1793, was £261,735,000, in January, 1816, the year following the defeat of Napoleon at Waterloo, it had risen to £885,186,000. In the Budget of 1919, five months after the Armistice between the Allies and the Central Empires, the debt had reached £7,435,000,000, of which the external portion was £1,350,000,000. In the Budget of 1929 the debt was £7,501,000,000.

When needy monarchs were no longer able to raise money either by force, by attacks upon the dental systems of alien citizens, or by forced borrowings afterwards repudiated, and statesmen were more or less bound by the conventions of financial integrity which hold less exalted mortals, a system of arranging for funds to meet the debt charges was an urgent need which quickly created its own means of fulfilment. National loans are now offered to the general public by the same machinery as that which offers the change of participation in any other financial transaction. The loan is represented by stock, which can be bought and sold, and so turned into cash at the immediate need of the temporary owner. This system has been described, not unjustly, as an arrangement whereby a community of good credit can raise vast loans and leave the repayment of them to posterity. Blackstone in his *Commentaries on the Laws of England*, traces the origin of the system of public borrowing to—

> " . . . the State of Florence, A.D. 1344; which Government then owed about £600,000 sterling, and, being unable to pay it, formed the principal into an aggregate sum, called, metaphorically, a mount or bank, the shares whereof were transferable like our stocks, with interest at 5 per cent, the prices varying according to the exigencies of the State."

The Dutch applied this system during the war with Spain at the end of the sixteenth century, and in our own country it was adopted during the reign of William III, when, in 1694, the Bank of England was founded, on the suggestion of a Scotsman, under "an Act for granting to their Majesties several duties upon tonnage of ships and vessels, and upon beer, ale, and other liquors, for securing certain recompenses and advantages in the said Act mentioned, to such persons as shall voluntarily advance the sum of £1,500,000 towards carrying on the war with France." This Act authorized the raising of £1,200,000 by voluntary subscription, and of £300,000 to be raised by subscription on annuities granted to the subscribers. On the £1,200,000 the Government paid 8%. This marks a definite advance in public borrowing, for it ends the tradition of Government borrowing from a few selected wealthy traders, and inaugurates the tradition of a Government issue in the form of stock to the public. It is a half-way house, for the Government then borrowed from a company incorporated for the purpose of making the loan, and the company issued its stock to the general public.

South Sea Bubble.

The new Bank of England was not alone in financing the Government. The notorious South Sea company, it will be recalled, was formed in 1711 for the purpose of trading to the South Seas, and during Harley's treasurership was induced to lend £10,000,000 to the Government, allowing the debt to be **funded**—that is, given the status of a debt raised for permanent purposes and either repayable at a distant date or not repayable at any definite date, in other words a debt implying an obligation on the borrower to meet the regular interest charges,

but not to repay the principal—and receiving in return a monopoly of trade with the Spanish colonies. In 1717 the company was persuaded by Walpole to find another £5,000,000, and in 1720 agreed to take up £32,000,000 of Government annuities and to persuade the holders to accept in exchange South Sea stock. The Government annuities had borne 7 or 8 per cent; the company was to receive 5 per cent till 1727, and 4 per cent after. In order to outbid the Bank of England the company agreed to pay to Government a premium of more than £7,000,000. In this transaction the company had heavily weighted itself, but as long as the public readily subscribed there was little danger. The public did readily subscribe, to an extent which caused many imitators of the company to arise and a gambling mania to seize the nation. (Money was actually subscribed for a project "yet to be revealed." Not until the frenzy of 1928, perhaps, were bubble promotions so readily supported as then.) The South Sea stock went to 900 per cent premium, and its directors, alarmed by the mania or jealous of other enterprises, took steps to prick some of the bubble companies. The shattering of public confidence, or the dissipation of public credulity, caused a panic as general as the mania. Everybody tried to sell, and the company itself, in the September of 1720, saw its own stock topple from 1,000 to 175. There was widespread ruin, and great public agitation against the company. A retrospective Act of Parliament had to be passed remitting the £7,000,000 due to Government, appropriating the private property of the directors for the relief of the sufferers and dividing the capital of the company, after discharging its liabilities, among the proprietors.

In those pregnant years between 1694 and 1720, the joint-stock companies were born. With the application

of the principle of limited liability (see Chapter XIII) to their constitutions the new era in finance opened beyond mistake. The history of limited liability is itself of some interest. Even in the days when every company had to obtain either a Royal Charter or the sanction of an Act of Parliament, the stakes of the participants were sometimes made the measure of responsibility for liability, but the Act of 1844, which simplified the formation of new companies, and the Act of 1855, which laid down that the liability of shareholders should be limited, made the rule what had earlier been the exception. The Joint-stock Companies' Acts of 1862–64 expanded the principle, and from those years to our own time the readiness of the ordinary private citizen to apply his surplus money to joint-stock enterprises has been an ever-increasing factor in the national mass and individual psychology.

§ 2

We have seen the creation of "stock" and have examined the meaning of the word "share." Using both words, from now onwards in the colloquial way, to mean the securities which are bought and sold between investors and speculators and which occupy the denizens of the Stock Exchanges, we can differentiate more closely between the two. (It must, however, be remembered that the word stock has also retained a second and general meaning, being used to indicate any kind of security, whether stock strictly so-called or shares. A stockbroker handles both stocks and shares, and it is a frequent occurrence to find dealers talking of stock coming into the market when they actually mean shares.) To some extent the differences have become technical and academic, but the main distinction is real.

Stock is differentiated from shares by the fact that it can be divided and transferred in odd and varying amounts. **Shares** are expressed in definite amounts and are not divisible. Let us consider two companies. Angora Goats Development Corporation has a capital of £100,000 in stock. On issue this stock was to be bought at par, that is, £100 bought £100 worth of stock. I applied for £50 worth, which was allotted to me. The quotations of the price of the stock in the market are given at so much per £100. After a good trading period Angora Goats Development Corporation gladdened my heart by the payment of a 12½ per cent dividend, and the value of the stock rose in the market. It was quoted at £200. I sold my holding for £100, it being bought in two lots, Jones taking £15 worth, paying me £30, and Thompson the other £35 worth, paying me £70. Since it was stock, I could, had it been convenient, have let Jones have £21 worth, or £28 worth. The second company, which we will call Noiseless Motor-hooters, Ltd., also has a capital of £100,000 in £5 shares. The shares were offered at par that is, £5 would buy one share valued at £5. I applied for ten shares and they were allotted to me. After a good year, following the passing of the Street Noise Abatement Act, the Noiseless Motor-hooters company paid a dividend of 15 per cent, following other years almost equally good. Their shares went to £7 10s. I sold my ten shares and received £75. Jones took three and Thompson took seven. In both cases Jones and Thompson received securities to the nominal value of £15 and £35 respectively, paying the current market price for them. But if Jones had, say, £42 to spend he could have bought a nominal £21 worth of stock (at £200) whereas he could not have bought an amount of shares to cost him exactly that figure. He would have had to buy

five shares, nominally £5, at the market price of £7 10s. per share, and find some other use for the odd £4 10s. out of his £42. In practice, stock is usually bought and sold in round amounts, very small or odd amounts being avoided where possible.

Bearer Securities.

The second difference between stocks and shares is found in the fact that whereas shares may be "bearer" securities, stock is always registered or inscribed. Stock, that is to say, is registered as being in the ownership of the holder who receives a certificate only to that effect, the certificate itself not being evidence of title (see page 167). Anyone holding such a certificate and wishing to sell the stock to which it has reference, must do more than pass to the purchaser this certificate, for the sale is incomplete without a deed of transfer. To the deed of transfer the certificate is attached, and on presentation of the two documents the stock is registered in the name of the new owner by the officials of the company. Inscribed stock demands the actual attendance of the holder (or someone holding his power of attorney) at the office where the list of stock-holders is kept, whenever a transference is made. The holder of inscribed stock has to be content with a mere stock receipt, an acknowledgment that his name is inscribed on the list of stock-holders but of no other significance. A stock certificate, while it is not evidence of title, is usually required by the company before a transfer is made. A stock receipt is not so demanded.

Shares, as we have said, may be either registered or "to bearer." Registered shares place the holders in almost the same position as stock-holders. They are enrolled on the share register, receive their dividend

warrants by post, and hold a share certificate which, like a stock certificate, is not in itself good evidence of title. In the case of bearer shares, the holder's name is not registered by the company. He receives his securities from an original subscriber or a subsequent holder, and the documents he receives are themselves good title. The "scrip" which he holds makes him a proprietor of that part of the company's capital represented by the face value of the paper bought. Bearer shares, it will be obvious, have the defects of their qualities. If they are lost, the title to the capital they represent is lost with them. If sold wrongfully by some one else, it is a difficult and sometimes an impossible business to dispute the title of the purchaser. The dividends are paid not to the holder on the initiative of the company, but by the company on the presentation of the appropriate coupon. These "**coupons**" are portions of the bearer share intended for detachment at dividend times. They have generally to be left with the company for examination, and the business of procuring the dividend due is thus made lengthy and tedious. It is a business which most bearer shareholders leave to their banks, who will undertake collection. None the less, the ease with which bearer securities are transferred has made them the most popular form of scrip.

Bearer securities cannot, by the Trustees Acts, be held by trustees unless the deed specially sanctions them. They are, from the trustees' own point of view, undesirable holdings, since the chance of loss or theft is more serious than with other securities.

In America there is a form of security which combines the advantage of the registered and the bearer scrip. It is a certificate bearing on the back a form of assignment. The holder named on the face of the certificate

signs this assignment form, and anyone, by completing the form, can make himself the owner of the security. The dividends, of course, go to the registered holder and are collected from him by the new owner.

Debentures.

In addition to the two main categories of securities there is the third category, that of **bonds**, with which we can also consider **debentures**. A bond or a debenture is the acknowledgment of a debt. The stock-holder or shareholder is a proprietor of the company; the bond-holder or debenture-holder is a creditor. Bonds and debentures are always expressed and transferred in fixed amounts, although an issue of bonds may contain bonds of different denominations. They are generally to bearer, but are not infrequently registered.

The majority of bonds which come on to the market are debts not of companies but of governments or municipalities. Such securities are often secured upon certain fixed items of revenue possessed by the borrower. The difference in status between a proprietor and a creditor with an English company will be obvious. The proprietors have to take the rough fortune with the good fortune of their enterprise. If the directors, whom in theory they appoint, mismanage the concern and dividends are missed, they have perforce either to tolerate the mismanagement or displace the directors—often a difficult matter—or sell their share of the enterprise to whomsoever will buy it. But the creditors in case of default have legal remedies to hand. They can sell up the company, or put a receiver in. If the creditors' claims on the concern are not met, the prestige of the company is impaired to a much greater degree than if it merely shows no profit to its proprietors. When, however,

creditors of foreign governments are not paid, no such immediate action is possible. It is true that a bond-holders' committee may sometimes force their own government to apply pressure, and history has seen many a battleship sent to enforce government obligations of this kind—we may even be said to have put a receiver into Egypt during last century—but speaking generally the bonds of foreign governments sell on the prestige of that government.

It will be seen, when we discuss the various kinds of shares, that the debenture-holders are considered, and rightly, to be in a much safer position than any other contributors of money, and for their security forgo certain other advantages. When, during 1928, certain companies were compelled to reconstruct their financial fabric there were attempts, and by financiers of great repute, to decry the creditor's rights enjoyed by the holders of debentures. Even an ex-Chancellor of the Exchequer lent himself to one such attempt. The distinction must, however, be preserved rigidly, that a stock-holder or a shareholder is a proprietor and a debenture-holder or a bond-holder is a creditor. If it is not so preserved the whole of our present system of company finance will fall to chaos.

Note to Chapter XIV

[The student who wishes to pursue the subject of stock transfers cannot do better than consult *The History, Law, and Practice of the Stock Exchange*, by Poley and Gould, where the procedure is explained in detail, and the legal rulings on the rights of each party to a transfer, both prior and subsequent to the event, are set out. This volume also gives as an appendix the rules and regulations of the Stock Exchange.

CHAPTER XV

VARIETIES OF SHARES

THE simplest form of company capital is that in which the whole amount is represented by ordinary stock or ordinary shares. Next in the gradations of simplicity is that in which the capital proper is reinforced by a debt in the form of debentures. Rarely, however, is a company so simply capitalized. More often there is a variety of forms of capital. If the ordinary share is the sole form of capital, the holders, as we have seen, are entitled to share in the profits and liable for the debts in proportion to the shares held. But the issue of other classes of shares complicates the position. Shares may actually be of three classes: **Preference** shares, which may be cumulative or non-cumulative, participating or non-participating; **Ordinary** shares, and **Deferred** shares.

The preference share gives to the holder the right to a certain interest before the profits are divided amongst the holders of other classes, and, in the event of the liquidation of the company, the right to a return of capital before any return is made to the holders of other classes. (It must be remembered that these rights are exercised only after creditors', i.e. the debenture-holders', claims have been met.) Cumulative preference shares extend the rights of the preference share further and guarantee the holders that if the dividend upon them is missed in any one year, the profits of succeeding years will be used to pay the full dividends which have accrued before being divided amongst the ordinary shareholders. If they are **Non-cumulative Preference** shares the dividend

is payable only from the profits of each separate year. A **Cumulative Participating Preference Share** carries the further right that after the agreed dividend has been paid, and after an agreed dividend has also been paid to the ordinary shareholders, the profits still available shall fall in part to the participating preference shareholders. Such shares are not common.

For the Cautious

The preference share, it will be realized, was created to meet the needs of the type of investor who prefers security to risk, and yet is not content with the security which he might obtain by taking the low rate of interest offered on "Gilt Edged" securities, such as Consols. (Recalling again that this is necessarily elementary, let me hasten to say that "**Gilt Edged Securities**" are those considered to be thoroughly safe, especially as to payment of interest, and that "**Consols**" is the colloquial name given to the Government's consolidated funds and consolidated annuities.) The ordinary shareholders of a company may find that the yield in interest from their investment may rise to dizzy heights or fall to zero as the fortunes of the enterprise flow and ebb, but the cautious preference shareholder, forgoing the wild delights of a possible high yield, is content to know that he will receive his fixed dividend as a first charge on the amount available for shareholders, however small it may be.

Deferred Shares are, in one sense, the counterpart of the preference shares. They do not receive a dividend until the classes ranking before them have been satisfied. Railway companies' stock, by special Parliamentary powers, is often split or doubled into two categories, preferred and deferred. The preferred receives a fixed and non-cumulative proportion of the profits, the deferred

takes the remainder. Railways have thus in some cases three kinds of stock-holders, those holding undivided ordinary, those holding preferred, and those holding deferred. Splitting or doubling stock into preferred and deferred is an operation which explains itself. In the split a holding of £100 ordinary becomes a holding of £50 preferred and £50 deferred, and in a double a holding of £100 ordinary becomes a holding of £100 preferred plus £100 deferred. The method followed is to so arrange the new holdings that they carry the same dividend as the old holding of ordinary stock. The doubling or splitting may be compulsory, in which case the old ordinary stock disappears, save as a legal fiction for the purpose of declaring on it a formal dividend.

"An Ingenious Device."

In industrial concerns the deferred shares are often a specially created class of security, with a purpose of their own. They are, as a rule, of small nominal value and are frequently taken by the vendors of a business as part payment from the new company. Let us suppose that a company has a large issue of ordinary £1 shares, say £1,000,000, and a small issue of deferred shares of lower denomination, say 10,000 at 5s. Should it be arranged that after the payment of a moderate dividend, say 7 per cent, upon the ordinaries, the remainder of available profit is to be divided equally between the two categories, the return to the deferred class is out of all proportion. If the company makes £100,000, of which £70,000 goes to the ordinaries, the deferred then receive £15,000, or half the surplus, to be distributed over holdings totalling in nominal va'ue only £2,500. This percentage is huge enough, but it will be enormously increased if all the authorized capital of £1,000,000 has not been issued.

These shares have been described by Mr. Hartley Withers as "an ingenious device for keeping for the original promoters or vendors a very substantial share in the profits and at the same time preserving for them an air of great modesty and moderation."

It is sometimes assumed, even by financial authorities, that deferred shares have taken the place of what used to be known as **Founders' Shares.** Where the object of the founders' shares was to secure a high proportion of the profit to the original promoters, without displaying too obtrusively the amount they hoped to take, they did fill the function now often filled by the deferred share. But founders' shares very often have quite another purpose, that of retaining the effective control in a few hands, irrespective of the amount of dividend yielded. There is, for example, one very prosperous newspaper enterprise in existence which pays a gratifying rate of interest to its ordinary shareholders, but which is, and will continue to be, governed by the holders of ten founders' shares. Financially, on their apparent merits, these shares, compared with the ordinaries, are not specially worth holding, but actually they convey what is more to many men than dividends—power, and power not only over the organization itself, but over the minds of the many hundreds of thousands who read the publications produced by the enterprise.

An Objection.

The main objection to deferred shares, or to founders' shares carrying dividend rights on the deferred principle, is that since the holders are generally those who direct the company, and since cupidity often overcomes prudence, there is always a temptation to strive to pay the other classes their agreed primary dividend in order to

participate in a surplus amount declared to be available. In other words, the enterprise may be sweated to provide more dividend than caution would approve, and money needed for reserves or development is thus deflected from its sounder purpose.

The deferred share is not, however, always created for the one purpose. It may be created as an extra bait for provisions of new capital. Where a company has a fairly considerable class of deferred shares ranking after the ordinaries for participation in final profits, the real effect of the issue, it will be apparent, has only been to transform the still so-called ordinary shares into preference shares. Deferred shares of this kind are often a better investment than the transformed ordinaries.

America, that land of excessive financial ingenuity, has created a new class of share which appears to be gaining favour with some of our own money-masters. It is the class of "**Shares of No Par Value.**" These shares are supposed to represent by a given number of shares the equity of the company, which is the surplus remaining after interest on bonds, debentures, and preference shares has been paid. Shares of no par value are not liable for stamp duty, and as there is no par or nominal value on which to calculate the percentage, dividends on them must be expressed in the amount paid per share.

§ 2

Shares may be either fully paid or partly paid. The usual method of issue is to offer the shares at so much on application, so much on allotment, and so much at call. If a share of the par value of £1 is so offered, and I pay 2s. 6d. on application, 5s. on allotment, and a further call of 2s. 6d., I have undertaken to provide £1 of capital but have only provided 10s. I am liable at any time for

the remaining 10s. It is quite obvious that if a company is authorized to issue capital, say, for £1,000,000, and needs for its immediate purposes only £500,000, it has a choice of procedure. It may issue 1,000,000 £1 shares, but call on them only 10s. per share. It may issue 500,000 £1 shares, leaving the remainder to be issued when the capital is required. It may issue 1,000,000 10s. shares, or 2,000,000 5s. shares, or 10,000,000 1s. shares, all fully paid-up, and so on, through the possible permutations. If a purchaser buys £100 nominal of stock he has entered upon no contingent liability, whatever price, high or low, he may have paid. But the purchaser of 100 £1 shares may have undertaken a liability of £50 or £25 over and above his purchase price.

In this connection a legacy of shares may prove an ill gift, since the unfortunate legatee may find himself called upon to pay a sum far in excess of his capacity.

The transferor of shares is liable for calls before the registration of the transfer, but he may, previous to delivery, pay any call made on registered shares, although not due, and claim the amount of the issuer of the ticket (see Chapter XVII). Many companies under the Act of 1862 and the Consolidation Act of 1908—and under the Consolidated Act which came into operation in November, 1929—have power to decline to register a transfer of shares where a call is due although not actually payable. Payment by the transferor on reclaim overcomes this possible difficulty as to a transfer.

§ 3

Although all the stock-holders or shareholders of a company are in the position of proprietors, they are by no means all in the same position, necessarily, with regard

to the control of the enterprise they jointly own. The various classes of shares carry different voting powers, governed by the **Articles of Association** of the company, which are its regulations and by-laws. Preference shares, for example, frequently carry only conditional voting powers, their holders having no say in the company's affairs until and unless their dividends have been or a certain period in arrears. In a later chapter we shall examine the formation and structure of companies, when voting rights will be reviewed at greater length.

§ 4

Ostensibly, and in a simple community, the motive for taking shares in a company would always be a desire to participate in some enterprise from which steady and consistent profit, or speedily realized wealth, was anticipated. Actually, as we know, the motive which prompts many investors and speculators to take shares is the hope that the shares themselves will rise rapidly in value, quite apart from the true economic progress of the company. When, in an earlier section of this book, we looked at currency movements, we saw that it was possible for men to buy and sell coins in the hope of making a profit on the appreciation or depreciation of the particular currency, and without any wish to participate in any way in the economic life of the country to which the currency belonged.

So it is with shares. If £1 worth of capital in "Invisible Paint, Limited," is worth £1 to-day, but is worth only 15s. to-morrow (because a rumour has passed round that the double-blank dotters in the domino factories are about to come out on strike) and may be worth 30s. next week (on a rumour that Great Britain is about to use invisible paint for her ships of war) it is quite certain

that some astute persons will begin to sell shares in the company against the fall and buy them against the rise. How this trafficking in shares is conducted we shall see later, but the point to be noted here is that those who traffic in them are not, in any true and exact sense, concerned with the actual economic state of the company. They are concerned with the market value of the shares as exchangeable instruments. If the rumour as to the use of invisible paint on ships of war is well founded and the company secures good contracts, it is quite obvious that the shares will be worth more, since there will be both more profit to distribute in dividends and more money to place from revenue into new assets or reserves, but the true share trafficker is not concerned with the truth behind the rumour. He is concerned only with the credence which potential buyers of the shares give to it.

Similarly, if "Invisible Paint, Limited," is preparing to amalgamate with "Transparent Varnishes, Limited," the prospects of the joint company being extremely favourable, the immediate future value of a share in either company will depend largely upon what terms are made for exchanging such shares into shares in the new joint company. Conflicting rumours as to possible terms will naturally affect the price which speculators or investors are willing to pay for such shares, but the share trafficker will not worry as to the reality of the value behind the transfer terms. He will be content if potential buyers believe in a suggested value for long enough for a deal to be effected. To the share trafficker, kind hearts are more than coronets, and simple faith than Norman blood.

The Shilling Share.

Until very recently it was the habit of companies issuing capital to invite the public to take shares of a

nominal value of not less than £1. The suppliers of the capital, speaking generally, were persons with a moderate sum of money to invest or persons with a lust for speculation. The true speculator, let me say, needs no great sum of money for his activities providing he can obtain a relatively small amount to cover his operations, as we shall see when we look into Stock Exchange transactions.

What genius created the small denominational share I frankly do not know, but in the early post-war years there came into being shares of a denomination as low as 1s. Around such shares there still wages a certain controversy. They are regarded by certain ostensible democrats as affording to the poor man a chance of participating in the prosperity of the companies which issue them, and of providing from his small store some of the capital which the country needs for the development of its industries, giving, thus, both a warm moral glow and a concrete return to the humblest capitalist. They are regarded, on the other hand, by stern and suspicious financial purists, as being nothing more nor less than a cute method of increasing the number of counters with which men may gamble and of tempting into the merry game more and more players, most of whom will be at the mercy of the older practitioners. The truth about the small denominational share probably lies midway between these extremes of thought.

I may, perhaps, be permitted at this point to widen the scope of this book for a moment in order to discover what social factors made the small denominational share successful. Before the War the small wage-earners who were blessed with the habit of thrift placed their meagre savings into deposit banks, like that conducted by the Post Office, or into building societies. The small wage-earner who was not blessed with the habit of thrift but

liked a gamble, confined his attentions to racing or football or some form of sport which invited speculation on its results. The War years inculcated in all classes a habit of investing money in Government stock or bonds. People were urged to buy War Savings Certificates or Victory Bonds. They were encouraged by the purchase of stamps at a copper or two each to build up enough shillings for the purchase of certificates costing 15s. 6d. and 16s. each appreciated over a period of years to their face value of £1. The response to the official injunction to buy these certificates revealed a wide constituency of small investors. These investors for the first time became accustomed to the idea of owning stock. It was little wonder that when the feeling of ownership had lost its first strangeness, there was a readiness to consider the purchase of dividend bearing paper other than that provided by the State. If a few shillings were spent on certificates with goods results, why should not a few shillings be spent on industrial shares with better results? The low denominational share met the readiness thus created and provided the small capitalist with a security for which he could apply without feeling that his application was for a number too trivial to be regarded with anything but scorn.

A Psychological Twist.

With the coming of the 1s. and 5s. share there was revealed an odd psychological twist in the community. If a company has a capital of £100,000, and any individual investor applies for ten shares at £1 each, he has asked for one-ten-thousandth part of the capital issue. If he applies for 200 shares at 1s. each, he has equally applied for one-ten-thousandth part of the issue. But many persons would shrink from making an application

for ten shares out of a total offered of 100,000 who eagerly apply for 200 shares out of a total offered of 2,000,000.

Again, while many a shrewd shareholder having bought £1 shares at, say, £2, and finding them down on the market to 25s., would not cut the loss but hold for a delayed but probable return to the higher figure, the same holder would sell impatiently 1s. shares bought at 2s. and dropped to 1s. 3d., although the amount of loss cut in the aggregate figure might be the same. The same tendency to allow the money sense to be dulled by accidental or incidental forms was noticeable during the War, when British troops paid in foreign paper money of low denomination failed to realize that a dirty bit of paper the size of a cigarette card and marked, say, one lira was, to all intents and purposes, 8d. in money. They *knew* its value, but did not *realize* its value, and tipped a waiter extravagantly in consequence or failed to dismount to recover from the roadway one such dirty note which might have fluttered from the rider's fingers outside an Albergo. Similarly, if many persons find themselves paid in notes, each depreciated to half its nominal value, twice the number which they are accustomed to be paid, they display a tendency for some time to spend more freely and lavishly. The money sense is befooled in a similar way when a garment marked 9s. 11¾d. is bought by a woman bargain-hunter who would not pay 10s. for it. The same human weakness is shown by card-players who blithely "go the pool" when they would not, if they thought calmly for half a second, "go" the amount which actually constitutes the pool.

Stagging Syndicates.

If the creation of the small denominational share met the readiness of a vast number of small potential capitalists

to find means of applying their capital to joint-stock enterprises, it also tempted many persons to speculate who had not heretofore contemplated stocks and shares as a possible medium for their operations. The man of moderate means and some knowledge of money had for many long years been able to "have his flutter" in securities, not by buying and selling the actual scrip itself, but by buying an **option** to buy or sell. (If I buy from someone an option to buy a month hence, or a week hence, 100 £1 shares in "Invisible Paint, Limited," now standing at 15s., and on the day of my option they have risen to 18s., the seller of the option has only to give me the difference and the deal is over, with no shares passing, and my outlay limited to the cost of the option. If the shares have dropped to 13s. I pay him only the cost of the option, my outlay being limited to that sum. The procedure would be the same were my option to sell the shares to him on the given day.) With the 1s. share, when a sum of a few pounds expressed in the number of shares it purchased seemed to represent a respectable application, people of far less than moderate means were able to club together and apply for a number of shares in a new company in the hope of selling on a quick rise. Junior clerks and their like formed "Stagging syndicates" for that purpose and senior clerks operated alone. (For a description of stags and stagging see Chapter XVII, and the reference page 220 above.) The rise of the 1s. share has thus had a double significance, it has introduced directly into industry a new stream of capital, which would otherwise have reached it only after incorporation through expenditure in larger streams, or which might have been frittered away in loose purchases, so divided as not to allow the capital force of the small contributories to aggregate into an appreciable

contribution in any one pair of directive hands, and it has introduced into finance a vast new public of speculators. In the long run the effect of the 1s. share can hardly be other than good, since any interest which brings the minds of people to a study of economic processes and industrial developments must eventually transform for the better the politico-economic relationship which those people have with the State and the community.

Against this suggested eventual good result must be set the indubitable ill that the readiness of masses of persons to subscribe a few shillings each has already led and will increasingly lead to the promotion of companies for the furtherance of projects either foolish, impracticable, uneconomic, or deliberately futile.

The statesman and the sociologist may pursue the implications of the 1s. share; for our immediate purpose it is sufficient to realize that the creation of such low denominational shares has to a very appreciable degree already altered financial usages and will increasingly affect methods of company formation.

CHAPTER XVI

COMPANIES, THEIR FORMATION AND FINANCE

THE formation of a private or public company has long ceased to be the casual matter that it was when Mr. Tigg Montague formed the Anglo-Bengalee Disinterested Loan and Life Assurance Company, with no assets and a board of imaginary directors. The procedure to be followed under the various Companies Acts, the latest of which received the Royal Assent on 10th May, 1929, is rigid. The Act of 1928, consisting of 118 sections and three schedules, became law in August, 1928, but only Sect. 92, prohibiting the hawking of shares, became immediately operative. The remainder was to come into operation on the passing of an Order in Council, with a tacit understanding that no such Order would ever be made, but that a new Consolidating Act, incorporating the old Act of 1908 and the new Act of 1928, would shortly be passed. That Act—the Consolidation Act of 1929—was rushed through its final stages in time to reach the Statute Book on the rising of Parliament on dissolution in 1929, and became operative on 1st November of that year.

In this chapter I shall endeavour to outline the methods by which a company is formed, and indicate the chief changes under the new Act, but the student who is preparing himself for a career as a company secretary, an accountant, a banker, or a book-keeper will find here no substitute for a study of the Act itself.

The law acknowledges two kinds of company, the Public Company and the Private Company. A private

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company need consist of no more than two members, whereas a public company must have a minimum membership of seven. There are many other distinctions, which will be indicated in due course.

Companies may be divided into five classes, as follows—

1. Companies limited by shares, in which the liability of the members is limited to the amount unpaid on the shares held by them.

2. Companies limited by guarantee and having a share capital, in which the members, in addition to being liable in respect of such amount as they have undertaken in the company's Memorandum to contribute to the assets on winding up, are also liable for any amount unpaid on their shares.

3. Companies limited by guarantee and not having a share capital, in which the liability of members is limited to the amount which they have undertaken in the Memorandum to contribute to the assets on winding up.

4. Unlimited companies, in which there is no limit placed on the liabilities of members.

5. Associations not for profit. These may be registered where the object of the formation is the promotion of some useful public aim—art, science, religion, commerce or charity. In such cases the word "Limited" is not required to be the last word of the name of the company.

The "**winding up**" of a company, by a common characteristic of the English language, is the opposite process from "winding up" a watch. A watch is wound up to make it go; a company is wound up when it is prevented from going. It may be wound up because of its financial inability to continue, because it is being amalgamated with some other company, because it is undergoing reconstruction, because it has ceased to fulfil its original purpose, or merely because its members are tired of it. The winding up may be voluntary or compulsory, and when wound up the company is said to be "**in liquidation.**"

We have already seen, in Chapter XIII, from whence

in a general way a company obtains its capital. In the case of a private company the money is generally found or even the actual concrete capital expressed in terms of money, by the actual promoters or their immediate circle, but with public companies the appeal is usually made to the public by means of a prospectus. If a prospectus is not issued, a " Statement in lieu of Prospectus " must be filed before any shares or debentures are allotted. Occasionally a business is transformed into a public company without fresh capital being required or demanded, in which case the owner of the enterprise merely transforms himself into the principal shareholder and finds six friends or associates to be co-members, thus making up the statutory seven.

Documents to be Filed.

The Incorporation of a Company must be achieved by the filing of certain documents with the Registrar. These are—

1. Memorandum of Association.
2. Articles of Association—unless " Table A " (see page 256) be adopted in its entirety, an alternative possible only to a Public Company.
3. Statement of Nominal Capital.
4. Declaration of Compliance with the Requirements of the Companies (Consolidation) Act.
5. Notice of the Situation of the Registered Office.
6. Particulars respecting Directors.

Of these, numbers 5 and 6 may be filed either at the time of incorporation or shortly after. The Declaration of Compliance must be made either by a solicitor engaged in the formation, or as by a person named in the articles as a director or secretary.

All the above documents are needed whether the company be public or private. In the case of a public

company the following additional documents are required—

7. Consent to act as Director.
8. Contract by Directors to take and pay for Qualification Shares (when not signed for in the Memorandum).
9. List of persons who have consented to act as Directors.
10. Prospectus or Statement in lieu of Prospectus.

These forms must carry the signatures of the directors except the list of persons consenting to act as such, which must be signed by the applicant, who may be one of the promoters, or directors, or the solicitor engaged in the formation.

When these documents are lodged at the Companies' Registry the registrar examines them, and if they are not questioned or challenged in any way they are provisionally accepted on payment of the duty and fees. A few days later the papers undergo a second scrutiny, and if they are passed the registrar then issues his **Certificate of Incorporation.** This certificate is dated the day of its signing, and is evidence that the requirements of the Act of 1908 in regard to registration and its preliminaries have been duly fulfilled, and that the company is authentically registered. From that date the company is an admitted legal entity. If it is a private company, it may commence business then and there. If it is a public company the secretary or one of the directors must make still another declaration that (*a*) shares held subject to cash payment have been allotted to an amount not less than the minimum subscription, and that (*b*) every director has paid on the shares he has taken or contracted to take, and for which he is liable to pay cash, the amount payable on application and allotment on the shares offered for public subscription. This declaration being filed, the registrar issues a "**Trading Certificate.**" If

there has been no prospectus, but only a statement in lieu thereof, the declaration varies in form. Until the Trading Certificate is issued, a public company cannot start business or exercise its borrowing powers, and any person contravening the Act in this way is liable to a penalty not exceeding £50 per diem. Any contract made before the date on which the company may legally start business will be provisional, and will become binding only on that date.

Fees to be Paid.

The fees and duties payable on the incorporation of a company are as set out below—

Fees payable on the formation of a limited company—	
Stamp Duty on Capital	£1 per cent
Fee Stamp on Memorandum of Association—	
Nominal Capital not exceeding £2,000	£2
For every £1,000 or part up to £5,000	£1
,, ,, ,, from £5,000 to £100,000 . . .	5s.
,, ,, ,, over £100,000	1s.
Maximum fee	£50
Deed Stamp on Memorandum of Association	10s.
Fee Stamp on Articles of Association (if any)	5s.
Deed Stamp on Articles of Association (if any) . . .	10s.
[1]Notice of situation of Registered Office	5s.
[1]Copy Register of Directors	5s.
[1]Declaration of Compliance with Regulations	5s.
[1]Return of Allotments	5s.
[1]Annual Return	5s.

The following table shows total fees payable (excluding those marked [1])—

£	£	s.	£	£	s.	£	£	s.
1,000	13	5	13,000	138	5	45,000	466	5
2,000	23	5	14,000	148	10	50,000	517	10
3,000	34	5	15,000	158	15	55,000	568	15
4,000	45	5	16,000	169	0	60,000	620	0
5,000	56	5	17,000	179	5	65,000	671	5
6,000	66	10	18,000	189	10	70,000	722	10
7,000	76	15	19,000	199	15	75,000	773	15
8,000	87	0	20,000	210	0	80,000	825	0
9,000	97	5	25,000	261	5	85,000	876	5
10,000	107	10	30,000	312	10	90,000	927	10
11,000	117	15	35,000	363	15	95,000	978	15
12,000	128	0	40,000	415	0	100,000	1,030	0

£100,000 to £525,000 add £10 1s. per £1,000; above £525,000 add 1 per £100.

FOR REGISTRATION OF ANY INCREASE OF SHARE CAPITAL. The same fees per £1,000 or part of £1,000 as would have been payable if the increased Share Capital had formed part of the original Share Capital at the time of registration, together with the Stamp Duty of £1 per cent on Capital.

FOR MAKING A RECORD of any fact required or authorized to be recorded by the Registrar under the Companies (Consolidation) Act, 1908, 5s.

For registering any document required or authorized by the Act to be registered (other than the Memorandum of Association or a Mortgage or Charge), 5s.

Registration of any Mortgage or Charge, up to £200, 10s.; over £200, £1.

It will be realized that with Stamp Duty on capital at £1 cent and a fee stamp rising to a maximum of £50, the total duty and fees may be a heavy sum. With a nominal capital of £100 it is £5. With a nominal capital of £1,000,000, it is no less than £10,052. It may thus be wise to give to a company a small nominal capital and to issue debentures later, but as a rule a company is registered with a nominal capital in excess of the nominal value of the shares actually issued, so that any fresh capital requirement does not entail the necessity of registering an increase of capital.

The Memorandum of Association is virtually the charter of the company. It must contain clauses stating—

1. The Name of the Company, with Limited as the last word.
2. The situation in the United Kingdom of the Registered Office.
3. The objects of the company.
4. That the liability of the members is limited.
5. The amount of the Share Capital with which the company is to be registered, and the division thereof into shares of a fixed amount.

These items differ slightly in the case of companies limited by guarantee.

The Articles of Association are, as I said in an earlier chapter, the by-laws which regulate the internal affairs and economy of the company. The Companies

(Consolidation) Act of 1929 contains a model set, described and known as "Table A." This Table may be adopted in its entirety, or adopted to special needs, or wholly ignored. The Memorandum and Articles of Association generally empower the company to operate in ways not actually contemplated as within its normal sphere of business. Since the Articles govern the conduct of meetings and the borrowing and other powers of the directors it is essential that they be studied carefully by any investor who contemplates joining the company. Certain provisions are by statute invalid, as, for example, a clause which empowers the company to purchase its own shares, or which extends the powers conferred by the Memorandum, or which affects certain rights of shareholders.

§ 2

Having examined, from the view-point of those forming a company, the documents which must be registered, we can now turn back to examine from the view-point of the investing public the most interesting of those documents—**the Prospectus.** In the days of the mining boom, a cynic described a bonanza as "a hole in the ground owned by a champion liar." Without being quite so harsh, we may safely regard every prospectus as a document drawn up in a mood of apparent ecstatic philanthropy by a champion optimist, with a view to extracting money from the pockets of others. When governments, or great municipalities, or similar bodies of high repute, great traditions and undoubted stability, invite loans, their solicitations are couched in restrained and dignified language, but the ordinary company inviting the public to subscribe money to its purposes develops a tendency not only to call all its geese swans, but to count all its chickens before the eggs from which

they are to be hatched have even been laid. I may, perhaps, be allowed again to quote Mr. Hartley Withers—

> "All prospectuses," he writes, "should be scanned in a spirit of jaundiced criticism, and with the most pessimistic readiness to believe that they are speciously alluring traps laid by some designing financier to relieve the reader of some of his money. No allowances should be made, and the benefit of the doubt should never be given to the prospectus. In fact, a large number of them are quite reasonable propositions put forward by quite honest men, but when they are of this kind they will, or ought to, stand the most sceptical scrutiny, and when they are not, it is a service to the community at large to put them as quickly as possible in the waste-paper basket. When they arrive by post or thrust themselves on your attention in the columns of your newspaper, your first instinctive thought should be that here is somebody wanting your money, and that he may be a descendant of Dick Turpin throwing back to his distinguished ancestor, and practising brigandage in a more modern and much less attractive form."

With that mood achieved, a prospectus may be safely perused.

In the Act of 1908 a prospectus is defined as "any prospectus, notice, circular, advertisement or other invitation offering to the public for subscription or purchase any shares or debentures of a company"; and must contain certain statutory particulars. The House of Lords, in the case of *Nash* v. *Lynder*, heard in November, 1928, decided that a statement "shown to any person as a member of the public and as an invitation to that person to take shares" is a prospectus. The decision is not unimportant and bears closely upon one of the changes in company law which is made by the new Companies Consolidation Act. In this case the events leading to the decision were simple. A certain company wanting more money provided one of its directors with typewritten copies of a document showing its position. One of these was given by the director to a friend, who in turn passed

it to a friend of his own. This gentleman eventually agreed to accept employment with the company and to invest £3,000. When eventually the employment was determined the investor set up the claim that the typewritten document which he had been shown was a prospectus which had failed to satisfy the requirements of the Companies Act. The defence was that the statement was not issued to the public, and hence was not a prospectus.

To be a prospectus a document must, then, be issued to the public (one member of the public being "the public") and must be an invitation to take shares. The Act of 1928 deals with another loophole by means of which the second of these requirements was evaded by some financial genius whose example has been widely imitated.

Under the wording of the Act of 1908 it was only an offer of shares which need be registered as a prospectus. If the actual offer of shares to the public could be made by somebody other than the company itself, the document need not be filed as a prospectus, and the document file in lieu need not contain certain items which the company was not anxious either to disclose or to emphasize. The procedure was easy. Instead of offering its shares to the public a company had but to allot them *en bloc* to an Issuing House, leaving the Issuing House to sell them to the public. The offer made by the Issuing House would not be a prospectus in the terms of the Act, and need not therefore contain the statutory items. The Act of 1928 to meet this system contained the provision (Sect. 32) that—

> "Where a company allots or agrees to allot any shares in or debentures of the company with a view to all or any of those shares or debentures being offered for sale to the public, any document by which the offer for sale to the public is made shall for all purposes be deemed to be a prospectus issued by the

> company, and all enactments and rules of law as to the contents of prospectuses, or . . . otherwise relating to prospectuses shall apply and have effect accordingly, as if the shares or debentures had been offered to the public for subscription . . ."

In addition, the section laid down that these offers must also contain the net consideration received or to be received by the company, and the place and time at which the contract under which the allotment has been made may be inspected. The effect of this section, as incorporated in Sect. 38 of the Act of 1929, will be to make it of less advantage to issue a statement in lieu of prospectus than to issue a straightforward prospectus.

The Normal Prospectus.

The normal prospectus should contain as its first line a statement that a copy has been duly filed with the registrar of joint-stock companies. Lacking this, the document is not a prospectus under the Joint-stock Companies Act, and the issuers have less responsibility for the accuracy of their statements. Next should come the announcement that the company has been incorporated under the Companies Act and so offers to its members the protection of the law of the land in which they live. A company may, of course, be registered in America or Italy or elsewhere, and be perfectly sound and honest. The danger is when a company which should be registered in England chooses to register itself elsewhere for undisclosed motives.

Following these particulars, and an announcement that an application will be made to the committee of the Stock Exchange for permission to deal in the shares, comes the statement of the company's capital and—if it has any—its debenture debt. This item demands close

scrutiny. If a company is saddled with a big load of debt or if it has an overwhelming proportion of preference shares ranking before the ordinary shares, or if both these characteristics are present, the ordinary shares are not only likely to be bereft of a good return, but the debentures and preference shares themselves may in consequence be lacking in real security. If debentures are offered, the prospectus should state the security behind them, which should be a mortgage on property and assets having a valuation which shall provide an ample margin in the event of realization. Debentures should be secured by Trust Deed, and the terms of this deed should be investigated by the potential debenture-holder. The rights attaching to the shares offered should be most carefully watched.

The Board of Directors.

After the statement of capital and debt comes the list of names of the personalities who are to conduct the enterprise, the board of directors, debenture holders, trustees, bankers, solicitors, auditors, and brokers. The **Board of Directors** is, as it were, a committee of public safety set to watch the interests of the shareholders, or would be if the ostensible relationship were the actual. In practice the Board usually takes shape and form before the shareholders take up their positions as members of the company. The selection of directors must naturally be governed by different considerations with each company. Some companies prefer to have a mixed Board of big capital holders and technical experts. Others have a fancy for capital holders only. Others, again, have a Board comprising a few dummies, whose names are attractive to the public, and one or two practical men who really understand the business of the company, and

in addition to filling the normal director's functions, also fill positions as officers of the company. The decorative type of director who is chosen for his name or his title, and whose chief interest in the company is the provision it makes for his director's fees, is known colloquially as a "guinea pig" on the (baseless) assumption that he draws a guinea per meeting. The powers of the directors are limited, as we have seen by the provisions of the Memorandum and Articles of Association, which also determine the qualification necessary to membership of the Board. The directors have certain legal responsibilities, but in the eyes of the law they are definitely *not* trustees (*Smith* v. *Anderson*, 1880, 15 Ch.D. 247), but salaried servants of the company they direct. Directors should not be trustees for debenture holders. They are representatives of the proprietors, and cannot fitly at the same time be representatives of creditors.

In theory the directors are the elected representatives of the shareholders, and the usual procedure is for a proportion of the directors to retire each year and to offer themselves for re-election. The re-election in practical business life is something of a solemn farce, but it does give to the shareholders' meeting an opening for protests or compliments.

Bankers and Auditors.

The name of a bank on a prospectus is no guarantee of the solidity of the company. The bank acts for the company as it acts for any other customer. That I have an account with Brooks's Bank is no guarantee of my honesty, any more than it is a guarantee of my intellectual brilliance. Still less is it a guarantee of my financial stability.

The name of the firm of accountants appointed as auditors is of more significance. The auditors are, like

the directors, elected by the shareholders; although in the case of a newly formed company the auditors will appear on the prospectus before the shareholders have had a chance of electing them. The choice of auditors will obviously be influenced by the type of accounts to be audited. Those which are the fruits of good and cautious finance are the accounts, as a rule, of sound business men, who are likely to choose sound auditors. Accounts which are the fruits of flashy finance are the accounts, as a rule, of business men themselves a little flashy, and likely to choose accountants renowned for their readiness to perform the strict business of auditing without endeavouring to influence the form in which the balance sheet is presented, rather than accountants likely to make themselves felt as critics of the form of presentation.

The name of the company's brokers is not always given on a prospectus, but, just as in Stock Exchange business a share is judged by the company it keeps, so a new company can often be judged by the brokers who have consented to allow their names to be associated with a prospectus.

The objects of the company must, as we have seen, be set out in the Memorandum of Association, which by law must form part of the prospectus. But the objects of the company are in a prospectus greatly enlarged and elaborated. It is here that the genius of the professional optimist has scope. The actual objects are garnished with hope and served with assurance. Without *suppressio veri* or *suggestio falsi* the drafter of a prospectus can inform his words with a glowing spirit of anticipatory triumph. Patents pending, or a process for manufacture unproved, or contracts to be negotiated, seem to have all the certainty of well tested sources of revenue. Even

prospectuses of companies which are formed to take over old established businesses sometimes have a habit of assuming that everything is for the best in the best of all possible worlds. Profits are shown and depreciation not dwelt upon, or profits for a short run of good years are shown, and the bad years immediately preceding, which may have been normal years, are not mentioned. Earning power is assumed to be capable of expansion without the evidence for such capacity being adduced. Contracts already entered upon are given, but not obtrusively displayed, and may affect the cautious and informed mind in making a true estimate of the real prospects of the venture. Extraneous considerations are imported to befog the judgment.

In 1928, for example, several automatic photograph machines were exploited by new companies, and several kinds of colour photograph processes. It was not uncommon to find a new company suggesting that its own prospects were rosy because some earlier enterprise in the same field was doing wonderfully well. That one or more companies flourish on the making of a particular commodity is no evidence that new companies will flourish. They may merely divide the available business, or fail to obtain any share of it in the face of well established competition. Similarly, demand is estimated and the assurance expressed that of that demand a stated proportion at least must fall to the new company. For such assurance there is no true justification. In the examination of prospectuses these things must be watched for and mentally discounted.

§ 3

A prospectus must contain the minimum subscription on which the directors may proceed to allotment. When

the investor applies for a certain number of shares he may receive the quantity for which he has applied, or he may receive only a proportion, or he may receive a letter of regret. It is common to find in the daily financial journals a paragraph, under a heading "New Issue Success," stating that the lists for such-and-such a company closed at 9.45 a.m., the issue being heavily over-subscribed. It is not infrequent to find that lists have been closed, and later to learn that the issue has been under-subscribed, and a large proportion left on the hands of the underwriters. Such closing of lists before a full subscription has been offered is generally a matter of tactics. Any subscriber can withdraw his application while the lists are open or before the directors proceed to allotment, and should an issue "drag" many will do so, and thus make a slow application into a fiasco. Since the company itself is secured by the underwriters of a full subscription it has no direct financial reason for closing the lists, but a list kept open and a response known to be poor may prejudice the company for long in its future. Another annoying practice is often encountered. Applications are sent, and applicants who have not received allotments are compelled to wait some time for their formal "letter of regret" and the return of their allotment money. Where an issue is many times over-subscribed, and application money makes a huge sum, a delay of a week or ten days means an accumulation of interest. This interest goes to the promoters, and the applicants lose it. In any individual case such a loss will be relatively and even actually small, but that it is incurred is a rankling annoyance. Since the extra cost of finding an agency or a staff to send out letters of allotment and regret and to return cheques together and without delay is not large, there is no excuse for delay. It is bad practice.

§ 4

When a company has commenced business it must hold, within a period of not less than one month and not more than three months, its statutory meeting. A public company must, seven days before the date of the meeting, send to all its members and debenture holders a report giving them knowledge of the shares allotted, the receipts and payments on capital account, and the preliminary expenses of forming the company. This report must also be filed with the registrar. If a company is limited by guarantee or is unlimited, no such meeting is demanded of it.

At the end of each year's trading the company must circulate to its members a balance sheet. The Act of 1929 compels a company to keep proper accounts and to lay both a balance sheet and a profit and loss account before its proprietors in general meeting. (Strangely enough, although this has for many years been the virtually universal practice, only by the Act of 1928 did the law insist upon it.) The balance sheet must contain summaries of the authorized and issued capital, the liabilities and the assets, with such particulars as are necessary to disclose their general nature, and to distinguish between the amounts respectively of the fixed assets and floating assets, information being provided in the case of fixed assets to show upon what basis they have been valued. Separate headings are to be given for such items as goodwill, patents, or trade-marks; preliminary and other expenses in connection with the formation of the company or with the issue of fresh capital; and the aggregate of the company's holding in, and its creditor or debtor relationship with, any subsidiary company. Here the Act of 1929 does make the law conform more nearly to

the often repeated wishes of sound financiers and auditors.

Balance Sheets.

The balance sheet is the shareholders' or investors' quick guide to the financial position of the company. It tells him whether the enterprise is solvent and whether it is well situated for the achievement of prosperity and profit. The ideal balance sheet will show at a glance not only, as it professes, the assets and liabilities, but the true nature of each. If, for example, a company has machinery which is outmoded, or if it has a modern plant which is idle because floating capital is not present to feed it with its raw material, the assets so represented are realizable perhaps, but are not of much profit-earning value at the date of the balance. It must, in this connection, be borne in mind that **a balance sheet can never be more than a summary of the company's books.** It gives the balances of the various accounts, and it may fuse together one or more of them, and unless there is some indication of the realities behind the accounts it will be of little real value to the reader.

Shortly after the passing of the Act of 1928 there appeared in *The Westminster Bank Review* a specimen balance sheet under the terms of that Act, which I reproduce on another page, partly to save myself the trouble of drafting another one and partly because it is not possible to better it. A study of this specimen will convey more than many pages of comment, but there are one or two points which, perhaps, can with some value be emphasized.

Capital a Liability.

The great secret of understanding a balance sheet is to realize and remember that it speaks for the company

as an entity and not for the shareholders in that company. The company has taken its capital from those shareholders, therefore it owes the money to them. Capital must appear as a liability. The authorized amount of capital is shown but is not carried into account, where the amount required for balance is that of the capital actually issued. Reserves and dividend equalization funds have come from profits, and profits really belong to the shareholders, therefore they, too, must be shown as liabilities. The balance brought in from profit and loss account is the profit available for distribution and comes over to the liabilities' side as the balancing item. On the assets side the items are never as straightforward as those on the liabilities side. Land, property, plant, buildings, and patents, have to be valued by somebody in terms of money before they can be shown. Investments shown at cost may have depreciated. A sound company sets aside some amount for depreciation, and may show this amount in different ways. A company owning valuable properties and plant has been known to show these items at a few pounds in its balance sheet. (In such a case there is a hidden reserve, which we shall discuss a little later.) Other companies show similar items as " valued by managers " or " valued by the Board." Such valuations may err on the side of extreme conservatism or extreme optimism as to the realizable value in the event of a forced sale. In reading a balance sheet these things must be allowed for, and the deduction as to the position of the company must turn upon them. This margin of difference in valuation affects equally the profit and loss account, which is really a statement of revenue or deficit on the year's working. The profit and loss account takes as its datum the stock-in-trade at the beginning of the period, it adds to this the quantity

value of stock bought and worked up for sale, and shows against it amounts received or owing for stock sold and stock on hand at the end of the period. It is not the duty of the auditors to check or supervise the valuers, whoever they may be, and upon the valuation, as I have emphasized, turns the real position of the company.

The Auditor.

What the auditor does is to check the keeping of the accounts and to certify that, on the information afforded to him by the company, the balance sheet shows the position of that company. Auditors differ, not only in their technique, but in the point of view which they take of their functions. I have myself worked on audits with a colleague whose reaction to the companies employing us was that of a robot. If the books were properly posted, and the accounts balanced, he was satisfied. Many accountants' clerks charged with the duty of checking postings are little different from the old railwayman who for forty years tapped the wheels, and when asked on his retirement by a congratulatory director why he did it, said he was "danged" if *he* knew. But the auditors are, after all, employed to protect the interests of the shareholders, and they can by judicious handling of the officials of the company exceed without arousing resentment the mere checking function. They can persuade the responsible persons to adopt a better form of accounts, and they can even influence the basis of valuations. But such persuasion is not actually a part of the duty of the auditors, and no auditor is to blame who does not challenge a mode of presentation which, while a little misleading to the uninitiated, is not definitely and unquestionably a falsification of the company's position

SPECIMEN BALANCE SHEET

Liabilities			£ s. d.
Creditors and Credit Balances including Reserve for estimated further Expenditure on orders invoiced, fall in value of Investments, Taxation Reserves, etc.			1,223,492 2 7
Capital—			
Authorized		£ s. d.	
100,000 6 per cent Cumulative Preference Shares of £1 each . . .		100,000 0 0	
200,000 5 per cent Cumulative Second Preference Shares of £1 eac . .		200,000 0 0	
4,320,000 Ordinary Shares of £1 each .		4,320,000 0 0	
4,620,000 Shares		£4,620,000 0 0	
Issued		£ s. d.	
100,000 6 per cent Cumulative Preference Shares of £1 each, fully paid .		100,000 0 0	
179,056 5 per cent Cumulative Second Preference Shares of £1 each, fully paid		179,056 0 0	
4,299,656 Ordinary Shares of £1 each, fully paid		4,299,656 0 0	
4,578,712 Shares			4,578,712 0 0
Reserve Fund			702,000 0 0
Dividend Equalization Fund			400,000 0 0
Profit and Loss Account—		£ s. d.	
Balance brought forward		161,442 5 3	
Profit for the year ending 31st December, 1927		743,820 9 6	
		£905,262 14 9	
Deduct	£ s. d.		
Interim Dividends paid 28th October, 1927			
On Preference Shares .	3,000 0 0		
On Second Preference Shares	4,476 8 0		
On Ordinary Shares . .	300,975 18 5		
		308,452 6 5	
			596,810 8 4
			£7,501,014 10 11

Assets	£ s. d.
Cash at Bankers on Fixed Deposit, and Current Accounts, and in Hand	704,585 2 5
Investments in Government and other Securities at Cost .	1,585,118 4 8
Shares in other Companies	422,332 14 3
Shares and Debentures in and Loans to Associated Companies including Balance of Current Accounts . . .	1,046,996 19 4
Bills Receivable	79,383 15 7
Debtors and Debtor Balances	1,301,638 8 10
Expenditure on Orders not Invoiced (balance) . . .	278,702 11 6
Stock of Merchandise and Work in Progress . . .	1,286,630 17 11
Freehold Land and Leasehold Property, Plant, Buildings, and Patents	795,580 16 5
	£7,501,014 10 11

either by misstatement or omission. In other words, an auditor as such cannot insist upon the company's taking a pessimistic view of its assets nor upon the balance sheet's containing a refinement of detail not demanded by the law.

Under the Act of 1929, auditors are given the right to attend any general meeting of a company at which any accounts examined or reported upon by them are to be laid before the members, and to make any statement or explanation they desire with respect to the accounts. In any event, the first item which the wise reader will examine for himself on a company's balance sheet is the auditor's certificate which appears at its foot. In that certificate auditors very often say much by saying little, and, when occasionally a qualifying phrase appears, it should be freely used as the basis of inference. While it is not necessary to be quite so jaundiced a cynic when reading a balance sheet as when reading a prospectus, a little healthy doubt as to the rigid integrity of all one's fellow-men is advisable. Under the new Act, the report of the auditors must be *attached* to the balance sheet. This has long been the practice, but the Act of 1908 left it optional whether the report was attached or whether it was merely referred to by the balance sheet. It should also be noted that no person who is a partner or who is employed by any officer of a public company can be appointed as auditor to such company.

The following is a summary of the principal balance sheet requirements of the Companies Act, 1929—

1. A distinction must be made between fixed and floating assets, the basis of valuation of the former to be stated.

2. Preliminary expenses and new issue expenses, including debentures, to be shown separately.

3. Goodwill, patents, and trade marks to be shown separately.

4. Holdings in subsidiaries to be shown separately, and also loans to such undertakings.

5. The balance sheet must give particulars of loans made to directors during the accounting period, including repayments during that period, and the total payments to directors, including commissions, etc.

6. Profit and loss accounts are now made compulsory, but the nature of the information to be given therein is not specified.

Depreciation.

I have spoken in the preceding paragraphs of depreciation. The wear and tear of plant or stock means a lessening of its value, and that depreciation must be taken into account if the company's position is to be truly shown. If the value of the items is shown in succeeding balance sheets at an increasingly lessening figure, the items are said to be "written down." When an item no longer appears at all it is said to be "written off." Let us suppose, for example, that our old friend "Invisible Paint, Limited," had when it started business machinery which cost £10,000. In the first balance sheet it is shown at cost. In the next balance sheet it is shown as worth only £9,000. In the next it is shown as being worth £8,000. At the end of ten years it may, perhaps, as in the case cited on page 267, appear as worth only £1. When assets and liabilities are balanced one against the other on paper, it would seem that the company is so much the poorer. Actually the machinery valued at £1 might fetch at least £5,000. Had the company wished it could have continued to show its machinery "at cost." The item would have consistently appeared at £10,000. But, assuming normal wisdom, on the liabilities side of the balance would have appeared a growing item of reserves against depreciation. Thus the actual position is shown equally well (or ill) whether we see machinery valued as an asset at £1 when it is perhaps still worth £5,000, or whether we see it valued as an asset at £10,000

with a reserve for depreciation of £9,999. If it were certain that the exact value of the machinery was indeed £5,000, the true position would be an asset valued at that sum or a reserve against the original £10,000 of £5,000. But no man can say the exact value of machinery. It is worth more if it is sold as part of a going concern than if it is sold as a solitary deal. With intangible assets like goodwill, or even trade-marks and patents, it is even difficult to estimate an approximate value. A very conservative and cautious company will write goodwill entirely off its books. So with investments. If a company has a reserve which it invests in the securities of other enterprises it may show them at cost, with a reserve fund to meet their fluctuations, or it may show them at their market price on the date of the balance sheet.

Hidden Reserves.

If the original members of a company never changed, it might well be to their advantage to build up immense reserves where profits permitted a surplus after payment of a fair dividend, and many superficial critics of company finance are inclined wholly to approve a policy which follows this course. But there are two sides to a question always. The profits earned by a company are earned for its members. Prudence will dictate the allocation of a proportion of profits to the duty of replacing plant and premises which are wearing out, or may wear out, or which may by some new invention be superseded and rendered abruptly valueless. Prudence will also dictate the allocation of profits to a fund which will prevent shareholders from suffering too big a drop in their dividend income during a bad year or a short sequence of bad years. But if more than a just apportionment of profits is made to these and similar purposes,

and particularly if the apportionments are made in such a way that the company accumulates a reserve which is not apparent, which is a hidden reserve, future members of the company will benefit at the expense of present or original members, for the company is worth more than is revealed, and those selling their shares in it on apparent values sacrifice benefits which they should participate in to persons who buy the shares probably equally unaware that such benefits will be forthcoming.

When reserves grow to a size which in the opinion of the directors is not justified by contingencies which may make a call upon the company's resources, it is usual to distribute them as special bonuses to shareholders or as bonus shares. If out of accumulated profits I, as the virtual dictator of the financial policy of "Invisible Paint, Limited," give to every shareholder one new £1 share for every five already held, it is obvious that I increase the capital of the company without increasing its earning power, and that the item which I have called reserve fund in my balance sheet is now partly diverted to the item of issued capital. My liabilities remain unchanged except in my book-keeping classification. But on the new shares I must pay dividends, so that if I am able to maintain the same rate of payment I shall have less profit to allot in future to reserve. I might achieve the same object in a slightly different way, by paying my shareholders a large dividend and granting to them the right to apply for shares of a new capital issue on favourable terms. In either case I have in effect diverted profits to capital use as acknowledged capital.

Watered Capital.

When we get capital spent upon objects which do not represent assets we speak of the company as having

"**watered its capital.**"[1] Water in the capital may be present because on the formation of the company it was necessary to expend money on the purchase of publicity and outsiders' goodwill by a grant of shares, or upon the acquirement of a mythical or inflated goodwill from the vendors of the enterprise taken over. Whether bonus issues can always be held to water the capital is a little doubtful. A company may have originally been under-capitalized, and the transformation of reserve to capital is then fully justified. The reserve transformed may have represented assets which are now represented by the new capital. The acid test must remain the relationship of the capital to the assets. If assets represented by £1,000,000 of capital are suddenly represented by £1,500,000 of capital—no addition to realizable assets having been made and earning power not having been increased—then the extra half million is water.

Good company finance is that which places a company in the happy position of having valuations approximating to its true assets; a reserve sufficient to meet possible contingent liabilities and to equalize an unexpected bad period with the normal; capital adequate to the needs of an expanding business, and an earning power sufficient to allow for a good dividend; a wise allocation to reserves, and special allocations to funds which tend to increase the goodwill and stabilize the prosperity of the enterprise, in which category we must to-day include staff pensions and welfare expenditure. Company finance which allows too wide a variance—either way—between balance sheet and actual valuations, which allows reserves and provision for depreciation to suffer in favour of dividends,

[1] The metaphor "watered stock" actually derives from an old American cattle dealer who literally watered his live stock before driving it to the weighing platform, thus giving the animals a temporary false weight and appearance.

or which too frenziedly accumulates such provision at the expense of the members of the company, is not good. It is, of course, preferable that a company should err on the side of guarding the future at the expense of the present than that of feeding the present at the risk of the future, but error either way reveals a lack of financial balance in the minds of those responsible, caused in one case by too cautious and in the other by too sanguine a temperament.

Invested Reserves.

Common sense will seem to teach the student of finance that the reserve fund of a company cannot truly be so considered unless it is invested outside the company's own business. From this point of view reserves used for capital purposes had much better be transformed into capital. This viewpoint was strongly expressed to the Board of Trade committee, but the Act of 1929 leaves the law with regard to the investment of reserves practically unchanged. There are three incidental alterations. It is laid down in the Act of 1929 that a separate statement must be made, in the annual balance sheet, of the company's investments in allied and other companies, and the investments if any, external to the business and its allies, and that the manner in which losses of subsidiary companies have been dealt with in making-up the balance sheet must be separately stated and certified by the directors. Sections of the Act also meet the general realization that hitherto the law has been somewhat rigid with regard to the repayment of capital when accumulated profits permit. (No company at present can take power to purchase its own shares, as the capital would thereby be illegally reduced.) Under the Act of 1929 powers may be taken to issue redeemable preference shares, and over-capitalization be thus prevented.

Broadly speaking, the law leaves the control of the investment of reserves to the Articles of Association. The general form which such clauses take is as follows—

> "Before recommending any dividend, to set aside out of the profits of the company such sums as they think proper to meet contingencies, or for equalizing dividends, or for special dividends, or for repairing, improving and maintaining any property of the company, and for such other purposes as the directors shall, in their absolute discretion, think conducive to the interests of the company; and to invest the several sums so set aside upon such investments (other than shares of the company) as they may think fit, and from time to time to deal with and vary such investments, and dispose of all or any part thereof for the benefit of the company, and to divide the reserve fund into such special funds as they think fit [with full power to employ the assets constituting the reserve fund in the business of the company and that without being bound to keep the same separate from other assets]."

The Articles of Association being part of a contract between the company and its members, this clause may be modified as circumstances dictate when the Articles are drawn up. If at any time the Articles are altered on the requisite three-fourths majority, the shareholders may strike out the words in square brackets or they may go further and leave the directors no option but to invest the reserve fund outside the company's business or in gilt-edged or trustee securities, or to invest a portion of the reserve in this way. There must obviously be a legal latitude in the matter, since otherwise the reserve could not be applied by the company when and where it might be most wanted in a crisis. The use of a reserve for capital purposes of expansion or improvement in a business saves the "preliminary expenses" attaching to the issue of additional shares or debentures. If a reserve could not legally be so used, one of these two methods would have to be resorted to, if and when new capital expenditure seemed desirable.

There is another aspect of the matter which has also to be considered. If a company by employing its reserve internally can make a steady 7, 7½, or 10 per cent, why should it be content with the 4½ or 5 per cent which would be made from gilt-edged or trustee securities? If the directors are competent to conduct the affairs of the company itself, they must be assumed to be competent to judge how best to employ the reserve fund. If the diversion of reserves to outside investment means a loss of liquidity and a decrease in earning power, as the cost of escaping what may be a very small and even negligible risk from internal use, the choice of the directors will obviously be that of internal employment, and if the law prevented that choice it would be operating against the interests of the members of the company and as a discouragement of accumulated reserves.

CHAPTER XVII

THE STOCK EXCHANGE

IN the first chapter of this work I remarked upon the prevalence of superstition in secular life. Two superstitions die very hard. One is that all journalists are superficial, and the other that all the merry gentlemen who earn their livings on the Stock Exchange are exceedingly rich. The term "a wealthy stockbroker" is so common that the adjective has almost become a redundancy. A grammarian might be excused from regarding the words "stockbroker" as having "wealthy" understood in parenthesis after it in all contexts. There is actually no more reason why a broker of stocks and shares should be any more wealthy than a broker of produce, or metal, or even of furniture. I mention this because it is essential to grasp the fact that securities representing capital have become to a large extent commodities, and, as we saw in an earlier chapter, unless the traffic in them is analysed as a traffic in commodities, the fluctuations of stocks and shares will never be thoroughly understood.

Once the joint-stock company had settled itself into its present shape and had become a recognized factor in industrial and commercial life, shares in its capital naturally passed from hand to hand without the purchasers necessarily knowing anything at all about the industry which the company followed. Even before the joint-stock company had been created, or evolved, there were men whose interest it was to buy and sell the public debt. Such men in the eighteenth century were in the

habit of meeting for the transaction of business at a coffee house in London, known as New Jonathan's, admission to which was obtained on payment of 6d. In 1773, New Jonathan's was glorified with the title of "the Stock Exchange," the habitués deciding that this title should "be wrote over the door." New Jonathan's Coffee House was not the sole resort of the stock exchangers. They met, too, at Garraway's and lingered about the Royal Exchange. The South Sea Bubble, as we know, gave an enormous impetus to dealings in shares and increased the number of habitual dealers in stocks and shares. Thirty years after the resolution to re-christen New Jonathan's as the Stock Exchange—that is, in March, 1802—there was opened the present Stock Exchange, which was "erected by private subscription for the transaction of business in the public funds." The building was enlarged in 1854, and again extended before the end of the nineteenth century.

Administration.

The London Stock Exchange is thus a building owned by a group of private proprietors. It is under the protection and regulation of no charter. It is controlled by no statute. Its capital has increased from the £20,000 which its founders provided to £240,000, which is represented by freehold, leasehold, and other property. This capital is divided into 20,000 shares, on which, in 1875, £12 per share was credited as paid up. In that year it passed under the constitution of a deed of settlement, which still governs it. The administration of the Exchange is conducted by the managers and the committee for general purposes, and these two bodies may please themselves whom they admit to membership and what regulations and rules they place upon business. Every

member elected must become a proprietor by acquiring either one or three shares, according to whether he is admitted with two or three sureties.

The managers represent and are elected by the shareholders, three managers—one-third of the Board retiring once every five years. The committee consists of thirty members who hold office for twelve months from the 25th March next following the date of their election, that date being fixed for the 20th of March, unless that date falls on a Sunday or official holiday, when election falls on the next business day. (The duties and procedure of the committee will be found fully set out and discussed in *The History, Law, and Practice of the Stock Exchange*, by A. P. Poley and F. H. Carruthers Gould, my own indebtedness to which I must acknowledge, and to which I commend the student of stocks and shares and their exchange.) The committee is a most powerful body, and, since it can expel or suspend members, its control is sufficient to prevent members from having recourse to any law but that of their own body in the case of internal disputes. It is a benevolent autocracy based on an initial democratic election.

Brokers and Jobbers.

Members of the Stock Exchange—which is known in the city as "the House"—are of two kinds, stockbrokers and stock dealers. The dealers are known as jobbers. On the provincial Stock Exchanges this division does not exist. The broker buys and sells stocks and shares for his clients. The jobber has no outside clients, but deals with the brokers and with other jobbers, thus making a market in which the brokers can trade. Two vital differences of function and attitude arise from this distinction. The broker owes his first duty to the client

who instructs him, and will by his clients be forced to interest himself in various markets of shares. The jobber has no duty except to himself, and the body of which he is a unit, and usually deals in shares of one market. The broker buys and sells stocks and shares for his client, and makes his own living by the commission or brokerage which he receives on the transactions. The jobber is theoretically the owner of shares which he buys and sells, and, like any other merchant, makes his living on the difference between the price at which he buys and the price at which he sells. This difference is known as the "jobber's turn."

The significance of the terms "markets" and "jobber's turn" will be clearer if we envisage for a moment the Stock Exchange itself and the manner in which business is done on it.

The Markets.

The frontage of the Exchange is not impressive. Frontages are of commercial value, and the three sides of the Exchange block are practically lined with offices. It lacks, that is to say, a façade, and its interior is little more impressive, for it is a building of irregular shape. There is a fairly common misapprehension that the various "markets" are in some way artificially defined within the building, that the mining interests and the oil interests, and the industrial and other interests, are in some way either walled off or partitioned. No such demarcation exists. The floor of the building, when business is being done, is a mass of men, and the air is filled with the noise of their voices. To the intruder it seems like a tale told by an idiot, full of sound and fury, signifying nothing, but both the noise and the grouping of the men to an initiate signify much. The members

stand about in groups, and others pass from one group to another. There is an incessant chatter and some shouting, the shouting being largely the result of uniformed officials—known as " waiters "—raising their voices to call firms and members wanted by messengers. Occasionally the conversational drone and the normal shouting is augmented by a burst of yells from one group or another.

It is by the grouping of members, and that alone, that the markets are differentiated. Gilt-edged, rails, mines, and so on, each make a group—or more than one group—which forms itself in the same part of the House each day, ready to deal in the securities in which it is interested. It is the jobbers who form the groups, and the members who pass are the brokers. Mr. Hartley Withers in his *Stocks and Shares* has given a very penetrating account of both the unit and the mass psychology of the denizens of the Stock Exchange, and of the conditions under which their business is done. Since the scope of this volume does not permit of more than an outline of procedure, I must content myself with a recommendation to the reader to take from Mr. Withers, or some other source, the psychological tone of the House, for it affects, very frequently, the course of Stock Exchange business and reacts incessantly upon share values. Not only is the House subject to what the schoolgirls call " pashes "—that is, sudden and apparently unreasoning infatuations for this or that share or type of security—but it is liable to display corporately what in an individual would be admiringly or derisively called the artistic temperament. In other words, it has moods, and for those moods somebody pays. But, like any other moods, the changes of tone and temper are not, as they may seem, really unreasoning, nor are the outside public made the sport of

the professional dealers and brokers. The House is, in reality, a delicate organism, rather than a mere organization, and it responds quickly to influences not felt by, or not available to, the generality of men acting as units. When the jobbers stand ready for business and the brokers pass from one to the other, they do more than consummate a series of bargains: they create the tone of the markets.

Brokers' Remuneration.

Although the brokers pass from market to market, or from jobber to jobber in the same market, each has a point in the House where he may be called, and many firms have a representative who is, as it were, on point duty—listening point duty. The broker, acting for his clients, has also to keep touch with the outer world. He may have to be in his office during the business hours of the House or his office may send to him on the floor of the Exchange instructions received from clients. It is the unhappy privilege of the broker not only to buy and sell for his clients, but to be treated by them as a guide, philosopher, and friend, in regard to what should be bought and sold. Strictly speaking, this is no part of his duty to his clients, but actually it is very often the function for which the client most relies upon him. It must be remembered, however, that no matter what advice he gives, his remuneration remains the percentage which he takes on the actual buying or selling transaction. He does not, like the barrister, receive a fee for his opinion as well as a fee for the actual work he does in public.

Members of the Stock Exchange are not permitted to solicit business by advertisement. A firm of brokers which advertises itself is not a firm enjoying membership

of the House. It does not follow that such a firm is not honest and trustworthy, but should it prove untrustworthy and dishonest, there is no redress for the client outside the ordinary procedure of the law, and then only if a definitely illegal act has been committed. Clients may be swindled without the swindle amounting either to absolute fraud or misrepresentation. Many people express bewilderment as to how they are to select a broker if the admitted brokers do not advertise. The procedure is simple, since it involves only a question to the nearest bank manager or a letter to either the editor of a financial newspaper or the secretary of the Stock Exchange itself.

It is the constant endeavour of the Stock Exchange Committee to safeguard the public from fraud, and the members are not admitted without election and the finding of securities.

§ 2

Let us now follow a normal transaction from its inception to its completion. I have been paid, shall we say, £200 by one of my publishers. This sum I decide to invest. After some thought and several talks with various wiseacres, and perhaps a chat with my bank manager, my broker, and seventeen financial journalists—it is noticeable, by the way, that the man with £200 to invest is much more of a nuisance to his friends and associates than the man with £200,000—I decide to buy £200 worth of ordinary shares in Invisible Paint, Limited, which I notice are standing at 30s. I instruct my broker accordingly.

Despite my general poverty and the small sum at my immediate disposal, my broker knows me for an honest fellow, and is cheerfully prepared to transact business

on my behalf. He sees that his jobbing book (which is his business notebook) is in his pocket, puts on his hat, and makes his way to the House. There he passes to the market which deals in industrial securities and looks for a jobber who will make him a close price. My broker is that knowing old gentleman, Mr. Sage. He knows all the jobbers and does not hesitate in his approach to his old friend Greene. His approach is governed by professional etiquette and regularized procedure, to say nothing of his native wiliness. He exchanges nods with Greene, who asks him if he has "anything to do." He might have, if the jobber himself is prepared for business. The eager Greene wants to know what business. Mr. Sage mentions the security and wants a price. He does not disclose whether he is a buyer or a seller. The jobber then quotes him two prices, one at which he will buy, the other at which he will sell, say 29s. 9d.: 30s. Whether shares are quoted by the jobber in pence or in fractions of £1, depends very largely upon the freedom of the market. Very often two shares of the same type will be quoted, one in fractions and one in pence, "Bats" and "Imps" being examples of this, as well as of the love which the city has for nicknaming securities. "Bats" are British American Tobacco and "Imps" are Imperial Tobacco Company shares. (Stock quotations are expressed in fractions. Thus, had I wished Sage to buy for me £200 worth of $3\frac{1}{2}$ per cent Conversion Loan, Sage would have gone to the appropriate market and Brown, the jobber, would probably have quoted him $79\frac{5}{8}$: $79\frac{7}{8}$.) The difference between the two prices is the "turn" which was discussed a page or so back. Mr. Sage finds the price made by his friend Greene quite satisfactory, so, without further haggling, he announces that he buys 130 Invisible Paint ordinaries at 30s.

Marking the Bargain.

The transaction is entered into the notebooks of both broker and dealer. Mr. Sage writes on the bought side of his book "130 Invisible Paint ordinaries," with Greene's name in one division, and my name, as his client, in another. Greene enters on the sold side of his book "130 Invisible Paint ordinaries, Sage, 30s." The broker then "marks" the bargain. This he does by entering it on a slip of paper with his signature, dropping the slip in a box, from which it is taken by the officials, in order that the deal may be included in the official record of business done for the day. There is no compulsion upon the broker to mark his bargains, and the record of business done may not contain all transactions. When the following morning I see in the record that Invisible Paint ordinaries have changed hands at 30s., which is the figure at which Sage has bought for me, I am content that the bargain has indeed been put through as per my contract note. I may also see the same shares marked as changing hands at 29s. 9d., 30s. 3d. and even 30s. 6d. If Sage has bought for me at or near the lowest figure, I am his devoted friend and grateful client. If he has bought for me at the highest figure, I begin to doubt whether the old gentleman is really fitted for his business, and whether senility has not already impaired those once keen faculties of his.

From his jobbing book, Mr. Sage has the transaction entered into the firm's day book or journal, where ample columns are provided for all the necessary calculations as to brokerage and stamp duty. The following morning the clerks of Sage and Greene meet in the settling room in the basement of the House and there, amongst their fellows engaged on the same business, check the bargain. Assuming there is no disagreement—disagreements being very rare, and referred by the clerks,

should they occur, to the partners—the transaction is entered into the ledgers of both Sage and Greene. At this stage it should be remembered that Sage has to work out his brokerage, whereas Greene is simply taking a profit. In the office of Sage and Company, Stock and Share Brokers, the transaction is entered both in the "jobbers' ledger," which records transactions with jobbers, and in the principals' ledger, which records transactions with and for clients.

The Jobber's Methods.

Mr. Greene, the jobber, also has the transaction entered into his journal from his jobbing book, and, after checking, the item goes into his ledger. At this point the position of the jobber is different from that of the broker. The broker has bought on behalf of his client, but the jobber has sold on his own account. He wants, therefore, to even his book. He may not have the Invisible Paint Company's shares and so he goes to another jobber, who in turn will go to another, and so on, until at length someone of the fraternity buys the requisite shares from a broker with the scrip to sell. Mr. Greene's profit is made on the turn between the price at which he sells to Mr. Sage and buys from his own source of supply.

The next step by Mr. Sage between the deal and its being checked, is to prepare a contract note stating that on my account he has bought 130 ordinary shares in Invisible Paint, Limited, at 30s., for settlement on, say, 5th August, subject to the rules and regulations of the London Stock Exchange. This contract note is signed by Sage and Company, members of the Stock Exchange, London. To the cost of the purchase is added the group of extra items which I must pay, the Government stamp on the deed of transfer, the company's registration fee,

the stamp on the contract note itself and Sage's commission. The note is then sent to me with a covering letter, informing me that the purchase which I instructed Mr. Sage to make was duly made and that the contract note for the shares is enclosed.

The Account.

Towards the approach of the settlement day Sage's clerks (see page 286) make out a ticket. The Stock Exchange account occurs in the middle and at the end of each month, except in the Consols market, which has a settlement once a month only. The first day—or first two days in the mining market—is **Carry-over Day**, when speculators who have not bought or sold for delivery arrange their business, by methods and for reasons which we shall examine in a moment. The second day is **Ticket Day** (or Name Day), when the names and descriptions of the buyers of registered stock and shares are issued by their brokers and passed to the jobbers who have sold the securities, who pass them on until they reach the firm which is actually delivering the securities to the new holders. The third day is **Account Day** (or Pay Day), when the transfer deeds are presented with the seller's signature to the broker acting for the buyer, who then actually pays for the securities.

The progress of the ticket from Mr. Sage to the real vendors of the securities is well routined. On ticket day the settlement clerks range themselves in the checking room in the basement of the House with a small box before them. Into this box are dropped the tickets of the firms to whom securities have been sold. Mr. Sage's clerk drops my ticket into Greene's box. It is endorsed by Greene's clerk and passed into the box of the jobber from whom he in turn bought, who transfers it to the

box of the other intermediaries until it reaches the seller. When on account day the transfer deed is delivered it is signed by the buyer and taken to the registered office of the company. The company informs the seller that such a deed has been lodged with them and that lacking immediate repudiation it will be accepted as being in order and the securities transferred.

A Default.

It is quite possible that at some stage of these proceedings one party or the other to the bargain may default. The rules of the House allow for that, and if the ticket is not passed to the selling firm by 2.30 p.m. on ticket day that firm may sell out, which means that the securities Sage bought for me would be offered through a Stock Exchange official to the highest bidder, and the buyer who failed to pass the name would be liable for making good the loss sustained by Greene or the other intermediary who suffered. Should the transfer deed be not forthcoming the broker can make a fresh purchase, but as transfer deeds take time in drawing up and signing, "**buying in day**" is put forward some ten days after the close of each account.

The above procedure only applies to registered stock or registered shares. Bearer securities are passed by the simple process of the buying and selling brokers being placed in touch by the intermediaries and the actual scrip being handed over.

A selling transaction follows much the course of a buying transaction, with all the relationships reversed.

§ 3

My humble and simple transaction displays the mechanism by which the bargains of the Stock Exchange

are effected, but the real business of the House is not done by brokers acting for such simple-minded persons as myself, with a few hundred pounds to invest. The popular superstition that there flourish on and around the Stock Exchange a number of astute gentlemen who, having no money, buy securities they do not want from other astute gentlemen who sell securities they do not possess is not altogether wide of the truth. Much of the business of the House is done for persons who buy shares they have no wish to take up or sell shares they have never owned, and who conduct these odd transactions with an inadequate supply of money.

Let us suppose that instead of wishing to invest in Invisible Paint, Limited, I desired to speculate in them, having had the information as to the forthcoming use of that company's product on British battleships. The shares standing at 30s. will rise, I suspect, to 35s. or even higher. If I can buy and sell within the time limit of one fortnightly account my operation is easy. My two transactions have only to be cancelled out, and I pocket the difference. But I may buy to-day and, when a week hence account day happens, I may be ready neither to sell again nor to take up the shares. What I have then to do is to carry over my shares through my broker by paying somebody to carry them for me until I am ready to close my deal. The carrying over is effected by the payment of a **contango** or **continuation rate.** In the eyes of the Stock Exchange every bargain must be completed. If Sage has bought 2,000 Invisible Paint ordinaries, he must either pay for them, find somebody else to pay for them, or be declared a defaulter. As I, the client, am not ready to pay for them, Sage finds someone who is ready to buy the shares on carry over day and will bind himself to resell them at the next account, at a

price known as the making-up price and for a rate known as the contango rate. The making-up price is an approximation to the quoted price of the security at noon of carry over day, and is made by the leading jobbers in the market. Sage may, if he can, carry over my speculative Invisible Paints with Greene from whom he bought them, or he may seek out a firm which lends on contango and so secure his cover. Virtually Sage sells 2,000 Invisible Paints at 30s. this account to buy them back at 30s. next account, paying 6 or 7 per cent, or whatever the rate is, on the value of the shares for the fourteen days. Sage is the "**giver**" and the firm with which he arranges the deal are the "**takers in.**"

Bulls, Bears, and Stags.

In this transaction I am, in Stock Exchange parlance, a "**bull.**" A bull is a person who buys stock or shares in the expectation of a rise. A "**stale bull**" is such a person who has held on for some time without being able to realize his expected profit. The fellow animal to the bull is the "**bear,**" who is a person who having sold stock or shares which he does not hold desires a fall before settling day, when he may buy them in at a lower price and so make his profit. In the Stock Exchange menagerie there is yet a third animal, the "**stag,**" who applies for shares in a new company with the sole object of selling them at a premium, without either holding them or subscribing for them. He is a kind of temporary bull with antlers on.

"Stags," however, often operate like anticipatory "bears" by selling shares before allotment, hoping to force the promoters of the issue to buy them at a premium. Those interested in such manipulations will find the history of one or two notorious "raids" in *Leaves from*

My Life, by Mr. Osborne O'Hagan, published as this book goes through the Press.

It must not be supposed that speculation is the sole reason for a carry over. Many other reasons affect the position. A buyer may not himself receive expected payments in time to pay for his own purchases or the actual securities may not be ready for delivery. But, generally speaking, continuation is a device of the speculator, and the machinery of carry over is for his use and convenience.

Contango and Backwardation.

If in my speculation with Invisible Paints I had acted on the other rumour, that the dotters of double-blank dominoes were about to strike, and had sold for a fall, I would have found myself a bear. Not being ready to deliver on settling day the shares I did not possess, I should have to borrow the necessary securities. In the ordinary way I should receive contango, but if the shares were scarce I would have to pay a premium on the borrowed stock. This would be called "**backwardation.**" Whether, when I am a bull, I pay contango, and, when I am a bear, I pay backwardation, is purely a question of supply and demand. If there is a bull account and plenty of stock available, money is in demand. The natural result is a contango. But if the reverse obtains, and there is little or no stock, the contango is converted into a backwardation. It is at this juncture in the affairs of the House that the movements of the money market begin to have their effect. As we saw in an earlier chapter, the weekly return of the Bank of England and the daily record of bullion movements are available to every one, and indicate, for those with eyes to read, the present state and probable tendency of the money

market. That tendency will obviously affect all rates of money lending whether inside or outside the walls of the Stock Exchange. Stocks and shares are themselves money securities, and a stringency of money will lessen backwardation rate, and by making contango heavier will check speculation.

"Caught Short."

When a jobber quotes a rate, he does so much as he makes a price, quoting what he would take as interest and what he would give. Direct touch between the principal's agents would eliminate this turn, and it is also possible for a buyer to avoid carry over cover inside the house by having resource to his bank, with which he can deposit the shares against loan. This means that contango rates are not forced upon the speculators except by general financial circumstances. If, of course, bears are in such number as to make obvious the total impossibility of stock being found to meet the commitments, they are at the mercy of the bulls as to backwardation. The bull only needs money, and has several sources of supply. The bear needs stock, and has only one source of supply, and that a limited source. Caught short with a large mass of his fellows also over-sold, he is in a hopeless position. When contango rates are low, when they are even, and when there is a backwardation it implies that sooner or later the bears who are over-sold will have to buy, and the second inference is that the market must strengthen. If the stock which they have eventually to buy is properly manipulated by the bulls, there may be a precipitate rush by the bears to cover their commitments, which will mean the stock being rapidly bid up. Conversely, a high contango rate means a big bull account, with eventual selling and tumbling prices.

§ 4

In addition to purchases made for clients who intend to hold, and to speculative business, there also goes forward the business of dealing in **options.** Options are of three types, which are (*a*) the **Put Option,** which gives the right to call upon the giver of the option to buy from the receiver a definite amount of securities at a fixed price; (*b*) the **Call Option,** which gives the right to call upon the giver to sell to the receiver a definite amount of securities at a fixed price; and (*c*) the **Put and Call Option,** which is a combination of both. Option business is a specialized activity. The benefit of the option is that it allows speculation with limited liability. If I have an option to buy or sell shares and the market moves against me, I pay nothing but the price of my option on them. As a general rule the option is at the day's market price plus an addition to cover accrued contango over the open period. The House procedure is that all optional bargains must be declared at 2.45 p.m. on the day before contango day for the securities affected, or, if that be a holiday, on the preceding business day. Options done for and declared on the contango day are to be for settlement, both as to option and firm stock, on the settling day following account. All rights in respect of options have to be settled by the allowance of such valuation on the option price unless notice is given that the securities will be claimed and delivery accepted if the option is exercised.

A "Side Bet."

The option, it will be seen, is what the poker player would call a side bet. If I buy from you an option to buy shares from you a week hence at their to-day's price,

I really bet you the price of the option that they will not be lower on that date. If my option is to sell the shares to you a week hence at to-day's price, I bet you the price of the option that they will not then be higher. It is true that for quite solid business reasons I may have need of such an option on certain shares, but the majority of persons who dabble in options do so from the same motive which prompts a man to bet on the turn up of a card. It should be noticed that an option to buy or sell at a fixed price on a given date is very different from an option to buy and sell at a fixed price during a period ending on that date. If I have an option to buy from you 1,000 Invisible Paint shares at 30s. on 1st April, to-day being 17th March, on the appointed day they may stand at 29s. 3d., and I will not buy. But on 20th March, they may have touched 31s. 3d. If my option could be exercised at any time during the period I would then have bought. The difference, strangely enough, is not realized by many people until they are surprised to find that it really exists. The analogy would be the difference between gambling that a given horse will pass the winning post first and gambling that at any stage of the race it will lead the field.

§ 5

Most prospectuses, as we saw in Chapter XVI, announce that an application will be made for permission to deal in the shares on the Stock Exchange. This statement is no mere formality, for no dealings, whether for cash or for account, are allowed on any new issue unless—with one or two specially noted exceptions—the committee permits. Shares or securities issued to vendors credited as fully or partly paid cannot be dealt in until six months after the date on which permission was given for dealings in the

shares or securities of the same class publicly subscribed for. Before permission to deal is granted certain documents have to be sent to the secretary of the share and loan department, three days' public notice of the application must be given, and a broker who is a member of the Stock Exchange must be authorized to give to the committee full information as to the security and to provide the members of the committee with whatever particulars they require.

If the security is of sufficient importance the committee may order the quotation to be put into the official list. The official list consists of the prices of bargains transacted on the Exchange, and is compiled from the card which the brokers fill in and sign when they mark their transactions, as we saw Mr. Sage mark his bargain with Mr. Green a few pages back. A bargain may not be marked immediately, but can be marked later, for the clerks of the House will mark it, with the concurrence of a member of the committee, on an application stating all details, and signed by both buyer and seller, the application being filed and laid before the committee at its next meeting.

New issues which are not subsequently dealt in on the Stock Exchange are not thereby hall-marked as being of a dubious character, unless permission to deal has been applied for and refused, when the reason for such a refusal will naturally interest the investor.

§ 6

Having glanced at the Stock Exchange in a detached and inquiring spirit, I shall venture to conclude this chapter by making a few observations for the benefit not of the academic student of finance, but of the ordinary citizen who is inclined to apply his own surplus income either to investment or speculation. The first advice

which must be tendered to such a one is that he should employ in his operations a good broker who is a member of the Stock Exchange, and should be wary of outside firms, many of whom are excellent and honest, but some of whom are not excellent and only intermittently honest.

Investments may be made for two objects, to secure a share, or stock, which will show a satisfactory yield of interest each year, or to secure a share, or stock, which will appreciate in value over a long period. Speculation, we may assume, is indulged in with the object of securing a quick and big profit by foreseeing either the rise or fall of a security, and buying and selling accordingly. An investment for capital appreciation in a very short period approximates to a speculation, but may be made with little or no speculative risk, the buyer preferring to forego interest payments for eventual gain, and knowing, on sound information, that the value of a company's capital must increase. From 1925 onwards, small investors have tended to look rather for capital appreciation than for good dividend yield, and with reason, since their dividend yield must go partly to the State in taxes.

It will be clear from what has already been written that many companies live a kind of double life. As trading concerns they pursue a steady and satisfactory destiny, each year's output and profit slightly bettering the last. As Stock Exchange names attached to counters they enjoy a more exciting career, their shares being now up and now down. Such fluctuations may be, and very often are, quite out of the control of the company, but they may also be cleverly manipulated. Rumours of various kinds cautiously and skilfully released, hints as to the dividend declarations, pessimistic after-dinner diatribes on the state of the particular industry by which

the company lives, information as to probable or actual competition, and various other devices are used by interested persons who for one reason or another may want to lower the market price of a firm's securities. Similar devices of opposite effect are used to send those securities up. A political agitation may do much to set certain shares wobbling. It is not always possible for the genuine investor to procure reliable information as to the true state of a given industry or of any particular enterprise, and if he does procure it, he may not have the strength of will to invest his money and continue to regard it as an investment.

Safety First.

Those whose lot it is either to advise or console the average investor, whether as brokers or in some other capacity, know well how difficult it is to keep the man or woman with a little money to purchases which are as nearly safe as anything in a faulty world can be. Still more difficult is it to persuade such persons that the process of buying securities involves some expense, since the jobber wants his profit, the broker his commission, and the State its dues. And most difficult of all is the task of instructing them in the art of understanding markets. The basic fact to remember is that every security has two values—its actual value in comparison with the proportion it bears to the total assets and estimated potentialities of the company, and its apparent and temporary value, which is the value it carries in a market where it is bought and sold on its " commodity " value. A share may rise because the company behind it is prospering or is about to prosper. It may rise because the sheep-like investing public and the wolf-like speculators are making it the object of their merry antics,

bouncing it up like a medicine-ball and passing it from hand to hand at a level well over that to which financial and economic gravity will eventually cause it to fall.

A careful analysis of the position of a company, both as to its financial and trading states, a study of prevailing prices—those quoted in the Press, it should be noted, are, as a rule, middle prices, an average—and the employment of a good broker may together enable the investor to appraise the relationship of the actual value of a security to its temporary market value, and if the investor has neither the facilities nor the aptitude for the first two of these things he would be wise to confine himself to gilt-edged securities, like Government stock, Corporation loans, the prior charges of Home Railways, securities guaranteed under the Trade Facilities Acts, and similar investments which may show him a fair dividend yield on his money, to banks or to what are known as the public utility companies, such as the great gas undertakings or bodies of the nature of the Port of London Authority. Certain securities of the gilt-edged class are "Trustee stocks," for under the Trustee Act they may be held by trustees unless specially prohibited in the trust deed. These—need it be emphasized—are the safest of all investments. Foreign Government Bonds, especially those floated under the aegis of the League of Nations, are also to be commended, although some of the minor States have in the past earned a bad reputation for repudiation.

Within the past few years we have seen the rise of large Investment Corporations, which are a boon to the small investor, since they invest his money for him on expert advice, and relieve him from the worry of income-tax collection. The Investment Corporation is really a form of co-operative investment conducted by private enterprise.

Speculation.

It cannot be too strongly reiterated that the technique, no less than the purpose, of investment differs considerably from that of speculation. It is true that both involve the selection and purchase of securities on the Stock Exchange, but in the one case the security is bought to hold, and in the other case the essence of the business is buying to sell. This means a repetition of transactions, each of which imposes a cost upon the operator. If a share is chosen as a speculative counter the estimated rise must be thought of as being subject to an immediate tax of some 3 per cent to 5 per cent in the way of necessary expenses. The commission on purchase, transfer stamp, and fee and contract stamp, will represent at least 2 per cent, and on the sale of the shares there will be a second commission to find. This means that unless one can see a minimum rise of 5 per cent a small purchase for speculation is foolish. Larger operations are not so much affected, since the ratio of charges decreases as the purchase increases. The stamp duty maintains the same proportion, but the contract stamp and transfer fee, which are small sums, sink to insignificance, and commission also is adjusted. Mr. A. S. Wade, who has long been a recognized mentor to a wide newspaper public, in one of his smaller brochures, gives a succinct demonstration of the manner in which charges affect the small speculator.

"In the life of a City Editor," he writes, "no complaint comes so frequently as that made about the various charges which accompany the buying of investments and speculative shares. Purchasers seem to think they have been 'done' when they find that buying 100 shares at 20s. 3d. costs 100 × 20s. 3d. and £2 13s. 6d. of expenses, giving a total of £103 18s. 6d. Should he wish to sell again shortly there is £1 6s. od. more in incidental expenses, so that his shares must bring £105 4s. 6d. to make his bargain show no loss. In other words, when he buys at 20s. 3d. for capital appreciation the shares have to go

to 21s. 0¾d. before he can see his own money back. The new investor almost always rebels against these incidental expenses, and, invariably, makes the mistake of thinking that the stockbroker is responsible for them all. In the above £2 13s. 6d. on the purchase of shares the expenses are divided as follows: stockbroker's commission, £1 5s., i.e. 3d. per share; stamp, £1 5s.; transfer fee, 2s. 6d., paid to the company for altering the shareholder's name in their books; contract note stamp, 1s. Thus the Government gets £1 6s. out of the simple deal; the company, 2s. 6d., and the stockbroker, £1 5s. I do not see any way of reducing these charges except by the reduction of stamp duty."

The charges operate as a tax on turnover, and must be envisaged as such.

The remuneration of the stockbroker, far from being excessive in such transactions, is remarkably small for the amount of service rendered. As we have seen, the broker is himself under heavy expenses. He must have his office and his staff of clerks, and has to bear a running charge for messages delivered to him from his office when he is on 'Change, in addition to the expense in which membership of the House itself involves him. Brokers' commissions are not haphazard charges. The minimum scale of commissions is laid down in the Stock Exchange rules (Appendix 39) and is varied only in transactions with country brokers of Provincial Exchanges, in the case of underwriting or the placing of new issues, and on continuations. On gilt-edged and trustee stock the commission varies from $\frac{1}{32}$ to $\frac{1}{4}$ per cent on stock, and from $\frac{1}{4}$ to $\frac{1}{2}$ per cent on money. On registered and bearer shares, other than certain American securities, the scale rises from $\frac{1}{2}$d. per share on 1s. share, to 2s. 6d. per share on £20 to £25, and thereafter to $\frac{1}{2}$ per cent on money.

The astute operator in shares watches the gradations of the commission scale carefully. Shares, for example, at a point above 15s. mean twice as much in commission

as shares at a point below 15s., for at that price the scale alters from 1½d. per share to 3d. per share. Between £15 and £20 the rate is 2s., and between £20 and £25 it is 2s. 6d., so that purchases on the turn of the rate, just below and just above the £20 figure, show strange anomalies. There is a ready analogy in the income-tax scale, where a point may occur at which it definitely pays a wage earner not to have an increase in his pay.

" Ex Div."

Another cause of much misunderstanding to the small investor is the right to a dividend on a stock or on shares which have been purchased prior to or after the marking of the security " ex dividend." The declaration of a dividend by the company does not determine the title to receive payment of that dividend. Stock may be held for some time after a declaration of dividend and yet the right to its receipt be forfeited on sale to a new holder. The deciding point is the declaration on 'Change that the particular stock or share is being dealt in on an " ex dividend " basis. This declaration is usually—but not, always—made in the early part of the account during which the company will make payment. A shareholder who is on the register of the Company when the dividend is prepared and voted is not thus entitled to receive the amount due on his holding if he sells out before the Stock Exchange declaration. He will receive the dividend warrant, but will have to pass it to the broker to pass to the purchaser.

Until a share is quoted " ex div." the amount of the dividend is " in the price." After the declaration of dealings " ex div." the quotation usually drops. A share " cum div." is obviously worth more than the same share " ex div." But when the quotation drops owing

to dealings "ex div." the shares assume an appearance of cheapness which often stimulates buying, which buying, in its turn, causes a recovery.

Bonuses and other "rights"—such as the right to subscribe new capital at special terms—are treated in the same way as dividends. Many such rights are saleable apart from the shares, in which case the company supplies to its shareholders "letters of renunciation" when the rights are granted.

There is one other point which should be stressed here for the benefit of any reader who comes freshly to the study of stock and share movements and business. It is the virtue of fractional amounts. The Stock Exchange thinks in fractions of the £, running down from $\frac{1}{8}$ to $\frac{1}{64}$. The tyro is apt to regard a $\frac{1}{64}$ as a niggling item, and to wonder why men who will cheerfully spend a £5 note on a dinner for two grow excited about narrowing a price to a turn of $1\frac{15}{32}$ to $1\frac{1}{2}$. The odd thirty-secondth multiplied by the number of shares means money, for $7\frac{1}{2}$d. is $7\frac{1}{2}$d. in whatever way you express it. It may seem absurd to mention such an obvious matter at all, but it is in the acute realization of such obvious matters that the money-sense lies, and in Stock Exchange dealings, more, perhaps, than in any other activity, do the old proverbial truisms hold good—"Many a mickle makes a muckle" or "Look after the thirty-secondths and the fat, round sums will look after themselves" might be the motto inscribed on every investor's book plate. For the speculator's book plate I recommend as a motto the first law of poker—"The secret of success is knowing when to get out."

CHAPTER XVIII

NATIONAL FINANCE

It is not proposed in this and subsequent chapters, which deal with national finance, to attempt more than a bare outline of the financial machinery and practice of the State, with a few indications of what fiscal theories and principles have inspired finance ministers in their application of that machinery. In *The System of National Finance*—a book which Mr. Baldwin, when Chancellor of the Exchequer, assured the House of Commons had been his bible—Sir Edward Hilton Young has provided the student of these matters, and the ordinary tax-payer, with a detailed account of how the nation conducts its financial business. Sir Thomas L. Heath, in his brochure on *The Treasury*, has recently given us a short account of the workings of that department. Five books—*Twenty Years of Financial Policy*, 1842–62, by the late Lord Iddesleigh; *Finance and Politics*, 1862–87, by Lord Buxton; *British Budgets*, 1887–1913, by Sir Bernard Mallet; *British Budgets*, 1913–14 to 1920–21, by Mallet and George; and *British War Budgets*, by F. W. Hirst and J. E. Allen—present a continuous record, with contemporary commentary, of national financial development. There are many volumes on theories of public finance and taxation, and the biographies of finance ministers from Pitt to Goschen provide a valuable, if diffuse, history of the political motives behind the abandonments and innovations of the last century. To these works, and to the study of *English Public Finance from the Revolution of* 1688, by Mr. Harvey E. Fisk, the student may turn for the detail which, in these pages, I cannot pretend to supply.

Political economy, it has been said, is but domestic economy writ large. If that be true, it is not untrue that national finance is but personal finance writ large. Both statements, however, require serious modification. The State, like any individual unit of its community, is under the necessity of obtaining money for its purposes, and, having obtained money, must use it wisely and prevent any lack of economy in the interval between its acquirement and its disbursement. But the means which it can exercise to acquire its money and the restrictions under which it spends, the responsibility it has to the sources of its revenue, and the interactions of its methods and scope of expenditure make the analogy faulty. The State was called into being only because the community could not exist unless certain functions were either performed collectively, or on the collective behalf by selected and representative individuals. The maintenance of order, the defence of territory, the provision of essential services, all find in the State the most efficient and convenient organization, and even facilities for enjoyment are constantly added to the amenities of communal life which the State is expected to provide. These services and the fulfilment of the functions attached to them cost money. The amount of money they cost is not, as a rule, determined by the free interplay of economic forces, nor is the payment ruled by considerations either of economic or personal convenience.

How Money is Procured.

How, then, in return for its services does the State obtain its money? It obtains it in four ways—five if we include borrowing—by taxation, by fees for special services rendered, by rents and by the profits on trading operations. Of taxes I need give no specific example at this moment,

since we are all too familiar with their nature and incidence and since we shall shortly examine them in some detail. Of fees for special services the law courts furnish the easiest example. Of rents the example is the yield from Crown Lands, collected by the Commissioners of Woods, Forests, and Land Revenues. Trading profits are shown by the post office and have been shown also by other departments.

The chief and outstanding difference between the State and the private citizen in financial matters, as has been noted by all writers on the subject, and which obtrudes itself upon the infant political consciousness, is that whereas the ordinary citizen, generally knowing approximately the extent of his income, endeavours to adjust his expenditure to that amount, the State reverses the process. It estimates the expenditure it proposes to make and then arranges its income accordingly. The amount of expenditure which the State will make depends less upon financial than political intention, and, without entering controversially into such questions, the student of national finance must realize how close is the reaction of one upon the other. Broadly speaking, we may say that the two main political schools of our time are divided in this respect by one line of principle. On the one side of that line are ranged those who would prefer the State as such to spend the bulk of the community's money for the benefit of the community as it is conceived by the persons controlling the State. On the other side are ranged those who would keep to an irreducible minimum the services rendered by the State and would thus leave the bulk of the community's money to be spent by the individual units of the community. By one group taxation would be employed to compel the people to pool their money in order to effect social and political reforms.

By the other group taxation would be employed only to provide means of payment for limited services, regarded as vital to national safety or public progress, such services as would have to be rendered if the community were to survive whatever the national temperament and whatever the national traditions might be. I reduce the clashing principles to grotesque simplicity in thus stating them, but I might reduce them to even more startling simplicity by saying that one theory holds that the worker owns his own wages and the other theory holds that the worker's wages are owned by the State. There are strong arguments advanced for both points of view.

A Double Weakness.

Even those who would increase the control of the State over the allocation of the national wealth and income are aware that the national system of finance has a double weakness when contrasted with most private systems of finance. It tends towards extravagance and towards a disparity between the cost of services and their value to the community, measured in terms of competitive services which might be available were there no approximation to monopoly or no unusual power possessed by the State machine. It also tends to make the providers of the State revenue the playthings of financial viciousness or ineptitude. Those weaknesses have to an extent been guarded against by the formulation and general acceptance of certain principles of taxation. A tax system must be productive. In the teaching of Adam Smith, the father of political economy, a tax should take from the pockets of the people as little as possible over and above what it brings into the treasury of the State. Taxes which cost much to collect and yield little when collected are unsound. The taxes should be certain

in two senses—the State should be able to estimate very closely what the tax will yield and the tax-payer should know how much he has to pay and when he will be called upon for his contribution. The system must, in addition, be not too rigid. Not only should there be taxes which can be varied in rate and changed in incidence, but the system should be elastic enough to allow for new taxes, to replace those that, from changing social habits or other causes, have become unfruitful. In order to ensure willingness to pay on the part of the community, the tax system should be equitable, as far as equity is possible to faulty human systems, both in its incidence and its benefits. But, most important of all, taxes should interfere as little as possible with the creation of new wealth and the aggregation of new capital. A tax which is progressive in its ill effects but not in its benefits is a bad tax, whatever its immediate yield and no matter how easy its collection. It is as possible to tax out of existence a revenue-providing industry or enterprise as it was to kill the famous goose that laid the golden eggs. In national, as well as in business finance a perpetual flow aggregating over a long period, more than any immediate yield which prevents or diminishes further flow, is preferable to that immediate yield.

Expenditure.

As with the raising of revenue, so with expenditure. There are certain general principles, commonplace enough, which should govern the State in its financial business. Sterile and luxury expenditure is obviously bad, and the retention of the money of the community for long periods between collection and disbursement is also bad, for it robs industry of useable capital. Expenditure which is achieved by the employment of costly staffs and spending

machinery, and expenditure which is made without thought as to its continuity, or to inaugurate an experiment in Statecraft which promises little or no public benefit, or to perform at greater cost some service already adequately and cheaply performed by private enterprise are also to be condemned. Expenditure creating debt without provision for general redemption (see page 331) is equally to be deprecated.

Our existing system of national finance has been virtually created during the last century and a half. With the publication in 1776 of Adam Smith's *Wealth of Nations*, the face of political theory changed, and theories of political finance changed with it. Smith was a middle class Scott. He was stolen in childhood by gipsies, recovered, grew to adolescence, studied at Oxford, renounced a career in the Church for literature and a series of academic posts, and lived to produce a generation of political disciples who eventually remoulded our financial system, if not to anything approaching perfection, at least a little nearer to the heart's desire of financial purists. Incidently, he was also responsible for the rise of political individualism, and, in consequence, for a savage and almost maniacal outburst of invective from John Ruskin, who regarded him as a kind of anti-Christ for daring to base a system of economy on the belief that "all men 'naturally' desired their neighbours' goods; and that in the name of Covetousness, all the nations of the earth should be blessed." "It is true that the half-bred and half-witted Scotchman" continued Ruskin in his wrath "had not gift enough in him to carve so much as his own calf's head on a whinstone with his own hand. . . . But, in leaving to every artless and ignorant boor among us the power of breeding, in imagination, each his own particular calf, and placidly worshipping that privately fatted

animal, Economical Theology has granted its disciples more perfect and fitting privilege (than worshipping an actual golden calf. . . .)." However strong may have been Ruskin's objections to the central doctrines of Adam Smith's individualistic philosophy, of Adam Smith's effect upon our public finances, there can be no denial. He was, himself, the detached analyst, the theorist, but in the younger Pitt he had a semi-disciple who was a practitioner, and who was able to apply the principles which the master had formulated. Pitt in 1792 declared his belief that Adam Smith had given to the world the best solution to all commercial and economic questions, and there can be no question that that belief influenced his financial policy.

Pitt and His Task.

Pitt, in 1783, found a National Debt amounting to £215,717,709, the kingdom at that time raising a revenue of £25,000,000 only. "The war which ended in 1783," writes Professor Holland Rose in *William Pitt and the National Revival*, "had been carried on in a singularly wasteful manner. Dr. Price computed that the increase to the National Debt owing to the war had been £115,654,000 up to January, 1783, when all accounts had not come in. . . . The increase resulted largely from the reckless way in which North had issued loans, so that bankers and subscribers, and, it is said, the ministers themselves, reaped large profits while the nation suffered. According to Dr. Price, loans which cost the nation £85,857,691, actually brought to the exchequer only £57,500,000. This resulted partly from corrupt practices, but also from North's endeavour to keep down the rate of interest to 3 or 4 per cent, the outcome being that, in the impaired state of public credit of the year 1781,

he had to allot £150 of stock in the 3 per cents and £125 in the 4 per cents for every £100 actually borrowed. Thus, the raising of a sum of £12,000,000 on these terms actually cost the nation £21,000,000: and interest had to be paid on £9,000,000 which never came into the exchequer. Obviously he would have done better to raise £100 for £100 stock, even had he given 6 or 7 per cent interest; for the experience of the past showed that in time of peace and prosperity the rate of interest could be reduced without much difficulty."

It was on a financial complex of that making that Pitt brought his faculties to bear in the Budget of 1784. He did not shake off North's habit of issuing low interest loans at absurd rates of discount, but instead of arranging the price of his loans with a few favoured supporters in the city, allotting scrip at low terms to his friends in Parliament, and generally using the transaction to his own and their interest, he threw the tenders open to public competition and the proposals sent in were formally opened at the Bank, so that jobbery was no longer possible. Pitt also turned his attention to the huge debt and began funding operations, that is, operations to convert the debt in such a way that the Government would be under no obligation to repay the principal but only to ensure the payment of interest. He also readjusted taxation on Adam Smith's principle that taxes which meant much to the payer, but little when they eventually reached the Treasury, were unsound.

Effects of War.

Pitt's financial progress was interrupted by the war with France in 1793. "Thenceforward," in the words of Hirst and Allen, "for twenty-two years public expenditure, owing, of course, entirely to the war, far

exceeded the tax revenue year after year. Among the financial and economic consequences of that long, often desperate, and always costly struggle, must be included an inconvertible paper currency, very high prices, an enormous war debt, and a multitude of burdensome taxes upon almost all articles of consumption. . . . The total debt contracted would have been less, had not Mr. Pitt, at the suggestion of Dr. Price, borrowed year after year for a sinking fund, which by the operation of compound interest was to sink the whole debt without burdening anybody. Whether Pitt was himself taken in by this mathematical magic, or adopted it from the deluded philosopher in the hope that it would impose on the public and so improve the public credit, is not quite clear. The fallacy was exposed after Pitt's death by an Aberdonian Professor—Robert Hamilton—whose treatise on the debt is a classic which all finance ministers and Treasury officials in all countries should read. . . ."

In 1798 Pitt introduced another innovation into national finance—the Income Tax. His budget speech, delivered on 3rd December, 1798, has long been a classic of financial exposition (it ends the second volume of Pitt's collected speeches published in 1817) and was the subject of almost as remarkable an effort by Gladstone in opening the budget of 1853. Both these speeches will repay study.

Peel and Gladstone.

After Pitt the many indirect taxes which had cumbered British trade were gradually lessened. Peel did much: Gladstone more. Peel, in 1842, reimposed the Income Tax and used it as a means of wiping out the duties on 750 articles of trade. Gladstone, in 1853, applied the same method. After Pitt, it is Gladstone who stands out as the great practitioner of national finance during the last

century. Morley in the *Life* has an illuminating passage with reference to Gladstone's financial significance.

> " When it is asked," he writes, " what original contribution of the first order was made by Mr. Gladstone to the science of national finance, we may return the same answer as if it were asked of Walpole, Pitt, or Peel. It was for Adam Smith from his retreat upon the sea-beach of Kirkcaldy to introduce new and fruitful ideas, though he, too, owed much to the French economists. The statesman's business is not to invent ideas in finance, but to create occasions and contrive expedients for applying them. 'What an extraordinary man Pitt is,' said Adam Smith, 'he understands my ideas better than I understand them myself.' Originality may lie as much in perception of opportunity as in invention. Cobden discovered no new economic truths that I know of, but his perception of the bearings of abstract economic truths upon the actual and prospective circumstances of his country, and the world, made him the most original economic statesman of his day. The glory of Mr. Gladstone was different. It rested on the practical power and tenacity with which he opened new paths, and forced the application of sound doctrine over long successions of countless obstacles."

Many have wished that the glory of Mr. Gladstone had not strayed from the financial to the wider political orbit. As a financier he was indeed able " to use wise and bold finance as the lever for enlarging all the facilities of life, and diffusing them over the widest areas." He was the great apostle of economy. Retrenchment was his idol. He said, in 1861, that with him the cost of a policy might be the factor deciding its adoption. " I do not think that the condition of this country with regard to its finances can be wholly satisfactory when in time of peace the income-tax stands at tenpence in the pound." It is not yet seventy years since that statement was made, and the income-tax to-day stands at 4s., with currency, admittedly, of only half the value.

After Gladstone's last tenure of the exchequer came a

period of advancing expenditure, caused very largely by a wave of Imperialism which swept both political parties from the old bases. In the mid-nineties Sir William Harcourt devised a new scheme of death duties, which have remained, with increasing incidence, part of our normal tax machinery.

A New Spirit.

With the vacation of the Exchequer by Mr. Asquith in 1908 and its occupancy by Mr. Lloyd George, a new spirit entered into national finance. (I must emphasize here that this book is not concerned with political differences of opinion. I seek neither to condemn nor praise the tendencies upon which I may remark.) The finance machine was, or was said to be, applied not merely for the raising of necessary revenue, but as an instrument of social readjustment. Taxes levelled at certain classes of society were suspect as being means towards eliminating or lowering the social power of those classes rather than as means of providing revenue for reforms and necessary services. The many social reforms for which the Asquith Ministry had to find money, such as Insurance and Old Age Pensions, required financing, but there was a feeling abroad that in some cases it was hard to say which came first, the hen or the egg—the desire to find money for a new service or the desire to find an excuse for levying an impost upon a selected interest. Whatever motive was behind Mr. Lloyd George's finance at that time—some of it violated the Adam Smith principles to an astonishing extent—there was this in its favour, that it did prepare the public mind for finance measures which became necessary during the world upheaval of 1914–1918. It is certainly true to-day, however, that the death duties and the gradations of income-tax have become, in effect,

means of adjusting social differences no less than means of raising revenue.

The long chain o finance ministers stretching from Pitt to Churchill has given us as salient features of our system graduated income-tax, death duties, graduated customs and excise duties (mostly for revenue purposes, but occasionally as a semi-protective measure against unfair and abnormal foreign competition), and a debt with a genuine sinking fund attached, whereby it may—and should—eventually be wiped from the nation's books.

A Strange Error.

Before turning to the machinery by which our finances are operated, one other point requires a moment's consideration. In the endeavour to arrive at an equitable system of taxation, Adam Smith fell into a strange error. He enunciated the sound principle that "the subjects of every State ought to contribute towards the support of the Government as nearly as possible in proportion to their respective abilities, i.e. in proportion to the revenue which they enjoy under the protection of the State." But he assumed, and wrongly, as most of his commentators have since pointed out, that capacity to pay could be based on the money proportion to income. In an earlier chapter I directed attention to what is known as "the social value" of money, and that aspect of income creates a gross inequality if impost is adjusted proportionately to income, since the same percentage proportion of a small income does not represent the sacrifice represented by the same proportion of a large income. If I, as dictator, take a tenth of £200 from a poor clerk and a tenth of £200,000 from a newspaper magnate, the deprivation is severe on the one and may be almost unfelt by the other. It is this fact

which justifies progressive taxation. Similarly, if the State raises some of its money by a duty on a commodity which is not adjusted *ad valorem*, another injustice arises. The man who contributes, say, 1d. an ounce on tobacco at 7d. an ounce has paid out of all proportion to the man who contributes 1d. an ounce on cigars which cost him 2s. 6d. each.

Despite the interruption of the Great War, the machinery by which the nation operates its financial business has not been greatly changed, nor have the basic principles of national finance altered. We are involved in attempts to reduce debts of abnormal size, we are paying individually to the State much greater sums in taxes, we have added certain administrative costs and some extra administrative machinery, we have expanded the taxable area of population, but beyond this alteration of scale there is little difference. This is largely owing to the fact that for war finance special machinery and expedients were used. But in the spirit of national finance we have departed very far from the economy of Gladstone's adoration. With a vast external debt, a huge internal debt, and a political conscience which has made the State a moral agent in the lives of the people and saddled the public purse with new burdens of semi-philanthropic, semi-insurance significance, national finance has developed a tendency towards new methods of revenue production and of revenue use. It is not my present function to criticize this tendency, but it must be noted that the financial machine which we are about to examine was not devised for many of its recent uses, and may in the future be subjected to severe strains and drastic adaptations to new purposes.

CHAPTER XIX

THE TREASURY

THE financial business of the State falls naturally into three main departments: collection of revenue, the holding of public money, and the expenditure of public money. There is, in addition, the business of raising money on loan. No money can be raised without the consent of Parliament, and to Parliament must be accounted the money expended. The procedure follows a plain course. The various spending departments prepare estimates of their needs, with a statement of how the money is to be spent. These estimates come before the House of Commons as "Votes." The House of Commons passes the estimates, vote by vote, and provides for raising sufficient revenue to cover the authorized expenditure. The taxes imposed by Parliament are collected by the Revenue Departments, which pay their yield into the Exchequer Account. From that account the Treasury issues funds to the Paymaster-General for the use of the departments according to the votes passed by Parliament. Through the Paymaster-General the departments spend their money. At the end of the Financial Year (31st March) the Exchequer Account is balanced and audited. Appropriation Accounts, which show how the money granted for each vote has been expended, are prepared, audited by the Auditor-General, submitted to the Public Accounts Committee of the House of Commons, and reported upon to the House itself. Throughout this circle, and over all the activities of the various departments, the Treasury exercises a general control.

Sir Thomas Heath has defined the Treasury as "the department which, subject to the control of the executive and to the authority of Parliament, is responsible for the administration of the public finances of the country. The Treasury is this by definition, as it were; in essence it is the one permanent institution which stands between the country and national bankruptcy."

The Treasury is, properly called, "The Commissioners of the Treasury" or "The Lords Commissioners of His Majesty's Treasury," and fills the functions once falling to the lot of the Lord High Treasurer. In constitutional theory the Board of Lords Commissioners of the Treasury consists of a First Lord, the Chancellor of the Exchequer, who is Under Treasurer, four or five Junior Lords, with a Parliamentary Secretary and a Financial Secretary. All these functionaries are members of Parliament and of the Ministry. Actually the Board is of no real importance. The office of First Lord, the Junior Lordships, and the Parliamentary Secretaryship, have degenerated into political offices which enable Prime Ministers and party whips to draw salaries for offices which entail no work in order that they may without remuneration fill offices which entail very hard work. The Chancellor of the Exchequer and the Financial Secretary to the Treasury are the active members. There is also a Permanent Secretary who is both the head of the department and the co-ordinating head of the whole Civil Service, and is thus the chief liaison officer between that service and the Cabinet.

Three Departments.

The Treasury is divided into three departments. The Finance Department is concerned with the revenue, loans, the public debt, the consolidated fund, all questions

of banking and currency, foreign exchange, procedure and the financial relationships of the Dominion Governments to the central Government. The Supply Services, the second department, are concerned with all questions affecting expenditure of the money granted by Parliament. The Establishments Department, as its name implies, is concerned with questions affecting personnel and staff, salaries, and the organization of all civilian posts and establishment whether in civil or military departments, and with superannuation. The scope of the Finance Department is enormous, and includes both the Budget, with its careful estimates of taxation yields, and the city business of the Government.

Attached to the Treasury are the Board of Commissioners of Inland Revenue, which is at Somerset House, and the Board of Commissioners of Customs and Excise. These are the great Revenue offices, and they are responsible to the Treasury ministers. The minor offices which collect revenue, such as that of the Commissioners of Woods, Forests, and Land Revenues, are also in direct responsibility to those ministers. The Post Office is not, although it yields a small revenue to the exchequer. These are the sources of supply.

The spending departments of State, the War Office, the Admiralty, the Air Ministry, the Ministry of Education, and so on, do not make their own payments, but, as we have seen on an earlier page, have their payments made through the Pay Office, which is under the nominal control of the Paymaster-General and the actual control of the Assistant Paymaster-General.

The two further most important annexes to the Treasury—annexed in function, not in location—are the Royal Mint and the National Debt Office. The National Debt Office has a somewhat misleading title. The work

of managing the debt is performed by the Bank of England. What the National Debt Office does (through the nominal National Debt Commissioners) is to perform the work of buying and selling Government stock for Sinking Funds and for the various Government departments.

Chancellor of the Exchequer.

In its relationship to Parliament the Treasury is represented by the Chancellor of the Exchequer and the Financial Secretary. The Chancellor of the Exchequer besides being, by separate patent, Under Treasurer, is also Master, Worker, and Warden of the Mint in England, Governor of the Mint in Scotland, and one of the Commissioners for the Reduction of the National Debt, the other two operative commissioners with him being the Governor and Deputy Governor of the Bank of England. In any other country than England he would be called Finance Minister, and as such he is answerable to Parliament for the collection of revenue, the means by which it is raised, the loans by which it is supplemented, the care and custody of the public balances, and all matters affecting taxation and exemptions. He cannot hope, of course, himself to attend to the detailed business of his department, but he is in constant touch with his high officials, who submit to him for final ruling all the delicate and important questions which come up during the progress of their work.

The estimates of the various departments of State are prepared under the active supervision of the Chancellor of the Exchequer. He is the watch-dog of the taxpayer. As such he is the natural enemy of most of his Cabinet colleagues. When Lord Randolph Churchill resigned the office it was because he could not persuade the Cabinet

to back him in his demands for more economy in the estimates of the two fighting services, and his successor, then Mr. Goschen, was not long before he too was embroiled with the Prime Minister on the same contention. "I do hope," wrote Goschen to Lord Salisbury in 1888 "that looking to the demands certain to be made on us with regard to the Army and Navy you will mercifully defend me against as many attacks on the Exchequer as you reasonably can. I don't like to feel that I am opposing *you* in opposing expenditure; but I don't know where we should be landed if the Chancellor of the Exchequer did not often stand out. I can assure you I hate this 'standing out' as cordially as you would, and think the position of guardian of the public purse a detestable one. My colleagues ought not to aggravate it by too many reproaches, or by thrusting the duty of resistance too exclusively on the Treasury . . ." In Mr. Gladstone's time, it has been recorded, the duty of refusing the applications of the departments could be performed by the Treasury without reason for the refusal being given, the onus of justifying the demand being on the departments and not the onus of justifying the refusal on the Treasury. In theory such is the position still, but modern tendencies have rather changed the attitude of the departments to the Treasury in its defence of severe economy.

Rationed Departments.

So much has Treasury control of the spending departments weakened in the past two decades that there has grown a school of thought which would reverse the procedure, and would allow the Chancellor, as it were, to ration the departments, rather than the departments to put in their estimates. This method has been held

to be incompatible with our constitutional practices. At present Parliament decides upon a political policy, which is embodied in legislation, and only after the decision to follow such a course has been taken is the question of financing it officially entered upon. A recent bill to provide poor children with boots, for example, was introduced without specific details of the cost of such provision or indication as to where the money for their purchase was to be found. The Ministry of Health, were it authorized and commanded by Parliament to provide boots for poor children, would include the cost in its estimates, and the money would be found by the Chancellor. But if the House of Commons reversed its whole procedure, and rationed the Treasury to a flat total sum, instead of passing the Departmental Votes, leaving the Treasury to ration the departments under Parliamentary approval, there would be a ban of a very practical nature placed upon the discussion of general policy. A new Gladstone, as Prime Minister, might make the cost of a policy the test of whether it should or should not be introduced, but such a procedure would be a very different thing. It is here that the analogy between the State and a private enterprise or a domestic household breaks down. A business might ration its merchandising department with ease, for it has no restless 600 members to insist upon a change of policy during some stage of the year's progress, but a Government cannot ration a spending department without entering upon a severe self-denying ordinance with regard to policy.

The advocates of rationed departments are sometimes inclined to overlook the two facts, that policies which are inaugurated by a Government, as a big naval programme might be inaugurated, are the policies of the Government and not of any department alone, and become the

policies of Parliament, and that recent weakening of the Treasury control in the Cabinet of expenditure is not owing to a weakening of the desire for economy, but to a strengthening of need for spending caused by the growing scope and intricacies of all active departments, which is itself owing to the rapid developments of modern civilization.

Opening the Budget.

The chief and most spectacular duty of the Chancellor of the Exchequer is to "open the Budget." The Budget was once an actual bag in which the Chancellor brought to the House of Commons his papers and accounts. It is the name now given to the speech in which the Chancellor reveals his financial plans for the year. It states the accounts in summary form, and in this respect the use of the word Budget differs in England from its use abroad, where the term is applied to a full vol me giving accounts in all detail. In the Budget—the preparation and presentation of which we shall examine in the next chapter—the Chancellor explains how he proposes to raise the money he needs for the coming year and how he proposes to increase or diminish taxation. Only when Parliament has approved and sanctioned his plans can the work of collecting and spending the proposed revenue go forward.

All the money which the Treasury eventually procures through its departments from the measures laid down in the Budget must be paid into the **Consolidated Fund.** This use of a single "bottle-neck" fund has two advantages. It makes for simplicity of accounting and it enables Parliament to exercise a more ready and knowledgable control. (In practice, the Army, Navy, Air Force, and certain other departments are allowed to

apply certain of their own receipts, but only under strict supervision.) The Consolidated Fund Account is also known as the Exchequer Account. The importance of the Consolidated Fund is indicated in the Resolution of 30th May, 1848 " that this House cannot be the effectual guardian of the Revenues of the State unless the whole amount of the taxes and of various other sources of income received for the Public Account be either paid in or accounted for to the Exchequer." The question will immediately occur that even so there is one danger to the revenues of the State which is not evaded by this system. It is the danger from the Treasury itself. The check there is provided by the fact that no money can be issued out of the Consolidated Fund or the Exchequer without the assent and consent of the " Comptroller and Auditor-General," whose duty it is to see that money is only spent as Parliament has sanctioned, and who is independent of the Treasury. This official on receiving Treasury requisitions satisfies himself as to the legitimacy of the demand and then authorizes the necessary credit at the Bank of England or Bank of Ireland. As auditor he later sees that the money so obtained from the Fund has not been misapplied to objects other than those for which it was granted.

Supply Services.

The English practice is to balance the national Budget each financial year, from 1st April to 31st March. In the accounts of such a year it is not the payments in respect of or belonging to that year which are included, but those actually made. The expenditure falls into two broad classes. There are, first, a number of charges more or less permanent, which are authorized by Act of Parliament either for a fixed period or until the Act is

repealed. No annual vote of Parliament is needed to authorize such charges. They are interest and sinking fund, and the cost of managing the National Debt; payments to the Road Fund, in relief of Local Taxation, and to the Exchequer of Northern Ireland; the Civil List and certain other pensions, Judges' salaries, and the salaries of other high officers of State, whose independence of conduct is more thoroughly guaranteed by a permanent grant than by an annual vote. These charges are published only in the volume of *Financial Accounts* presented annually to Parliament. They amount to some £400,000,000. In the last pre-war year they were under one-tenth of that sum. The second class of expenditures includes the charges for military, naval, and air defence, civil government, the conduct of the postal services and the cost of revenue collection. These charges are covered by annual grants, voted in a Parliamentary Committee of Supply, and called grants for **Supply Services.** The estimates for these services are five in number: (1) Navy Estimates; (2) Army Estimates and Ordnance Factory Estimates; (3) Air Force Estimates; (4) Civil Estimates; (5) Revenue Department Estimates. The last two are both prepared and presented by the Treasury. The others are prepared and presented by the departments concerned, but are submitted to and approved by the Treasury before presentation.

When the votes on these estimates have been passed, funds are provided to meet them by placing at the disposal of the Government "Ways and Means." When a great many votes have been authorized the House of Commons resolves itself into a **Committee of Ways and Means** and votes a general grant out of the Consolidated Fund to cover the total so far passed. This vote of the Committee is reported to and approved by the whole

House, and is embodied in a Bill which passes both Houses of Parliament and receives the Royal Assent. Then, and only then, can the money from the fund be issued. Each session sees two, or more, of these bills presented. The first is passed before the end of the financial year and is called the Consolidated Fund (No. 11) Act. Another is passed at the end of the session and is called the Consolidated Fund (Appropriation) Act. By this second Act the whole of the votes of the House in Supply are ratified and the money to meet them authorized for issue.

Supplementary Estimates.

Supplementary estimates can be introduced if further requirements are necessary. A famous Chancellor has, however, laid it down that "it is a great and sound rule of financial administration to make a great and serious matter of these supplemental estimates, which disturb the annual reckoning with the House of Commons. It is most important to keep that annual reckoning definite and fixed. This cannot always be done; but in the case of exception, it is important that the disturbance itself should as far as possible be definite and substantive, and not in itself be liable to the chances of further correction. . . . In the Civil Branch we have introduced a new system, which seems to require them as a normal part of our system. And this is a very serious evil. . . ." (Gladstone to Goschen, 9th July, 1872.) If Supplementary Estimates are presented early enough in the year they are taken either after or with the original estimates, and embodied with the sums voted on the original estimates in the Appropriation Act. If not, they are presented to the House when it meets in the Spring, and the batch is covered by a vote in Ways and Means, and ratified in the

Consolidated Fund Act before the end of the financial year. The worry of Supplementary Estimates, as of so much other business, falls on to the Financial Secretary to the Treasury, who is probably the hardest worked member of the Administration of which he is a member.

§ 2

In the Consolidated Fund and Appropriation Acts is one clause which we must examine here before we consider in detail the preparation and presentation of the Budget. Revenue does not always come in when it is most needed, and these Acts authorize that "The Treasury may borrow from any person, by the issue of Treasury Bills or otherwise, and the Bank of England (and the Bank of Ireland) may advance to the Treasury on the credit of the said sum (i.e. the sum voted for the services of the year) any sum or sums not exceeding the whole." This brings us to the contact which exists between the Treasury and the Bank of England.

The Bank of England, as we have more than once seen in the progress of this book, has in its keeping the account of the Government, and manages the National Debt. This latter part of its work involves the keeping of the registers of Government stocks and the payment of dividends to stockholders and the issue of new stock, which includes the issue and repayment of Treasury Bills and Exchequer Bills. It receives from the Government for its services remuneration at fixed statutory rates, giving neither interest on deposits nor security. When, in Chapter X, we discussed the Bank and its weekly return we saw that the amount of money held by the Bank for the Government was shown as "Public Deposits" an item devoted to the balances of the various State departments and to no other sums. This

item covers the Exchequer Account, the balance of the Paymaster-General on money going from the Government to its creditors, the balances in the hands of the Board of Customs and Excise and the Board of Inland Revenue, balances awaiting investment by the National Debt Commissioners, and balances in the hands of the Post Office, the Courts and other sections of the Governmental machine.

Exchequer Balances.

The " Public Deposits " item in the Bank Return must not be confused with the Exchequer Balances, which are published in the Treasury Return of National Income and Expenditure each Tuesday in the *London Gazette.* Some public money is shown in the omnibus item of " Public Deposits " in the Thursday Bank Return which never enters the Exchequer Account. When the Exchequer Account has issued credit to the Paymaster-General, after requisition (see pages 317 and 319), the Exchequer Account is depleted and the Paymaster-General's Account augmented by the sum issued, but, as both are with the Bank, the " Public Deposits " item is not affected. As Sir Hilton Young in his *The System of National Finance* points out, " there is no necessary correspondence between minor increases and decreases in Exchequer Balances and Public Deposits. When big issues are being made from the Exchequer Account and are being rapidly disbursed by the Paymaster-General on account of the departments, as at the end of a quarter, the two visibly decrease together, and when the revenue is being rapidly collected and credited to the Exchequer Account the two visibly increase together: but at other times their movements up or down are not necessarily simultaneous."

Treasury Bills.

The Treasury Bills on which the Treasury is authorized to borrow by the Consolidated Fund and Appropriation Acts are ordinary bills of exchange backed by the credit of the Government. Bagehot advised recourse to this means of borrowing, and in 1877 the Treasury Bills Act gave power to issue such Bills. In 1902 the Appropriation Act and Consolidated Fund Acts were made the vehicles for power to borrow on such bills for Ways and Means. In that year the strain of the Boer War caused such a discrepancy between revenue and expenditure that the Bank was not disposed to supply temporary funds from its own resources. Any bill issued under the Consolidated Fund Act or the Appropriation Act must be dated for redemption not later than the end of that financial year, and cannot be renewed under the powers of the Treasury Bills Act.

Treasury bills, it will have been realized, are of far wider use than Ways and Means borrowing instruments. The mass of such bills outstanding represent issues to meet maturing debt. The War Loans Act gave a general authority to re-borrow and the bills are not affected by the ending of the financial year. The method of issue is simple. A warrant is sent to the bank, and the bank does the rest. A public notice invites tenders for the bills, and on the day appointed the tenders are received, the price offered being, of course, fixed by the discount the tenderers desire. The Chief Cashier's department considers the tenders and allots the bills.

The other means of borrowing open to the Government are twofold, on overdraft from the bank, where the item is shown as advances on Government securities, and loans from the balances of other departments to which the Treasury can turn. The Post Office, the Paymaster's

Department, and the National Debt Office, for example, have money for temporary investment.

§ 3

The management of the National Debt will be understood after another glance at the composition of the debt itself. We have seen in earlier chapters how the debt originated, and how public purchases and social reforms with successive wars and calamities added to it. We have also remarked that revenue upon which the exchequer has counted may not come in to time. This means that the items which make up the debt differ in character. Some portions of it are either long standing commitments, legacies from old wars, or the like; other portions are merely temporary shortages. **The Funded Debt,** which we have already discussed, is debt which has been converted into annuities, the principal of which need not be repaid until convenient. It includes consols, the Conversion Loan,[1] and the Government's permanent debt to the Banks of England and Ireland, upon which the Government pays interest at 2½ per cent. This debt is part of the security upon which the issue of paper currency is based. Similar to the Funded Debt is that portion represented by redeemable stocks of long date. These form a link with the **Floating Debt.** The Floating Debt includes such items as Treasury Bills, Savings Certificates, Ways and Means advances.

Some of the debt has been incurred when borrowing could only be effected at a high rate of interest. When better times arrive, and money is cheaper, it is to the advantage of the Government, as to any one else, to borrow cheaper money with which to re-pay the dearer

[1] Government loans are issued much as an issue of capital is made. They can be virtually underwritten by " placing firm " a portion of the loan at a slight discount, as was done in November, 1929.

money. This operation is known as Conversion. With Government stock that is not of fixed redeemable date the holder is under compulsion to surrender his stock for its nominal value at due notice. If at a given time it offers £100 for each £100 of stock held or an alternative security, at lower interest, but more attractive than similar kinds of security into which, at some expense, the holder could put his money, the strong chance is that the holder will convert his holding of the old into a holding of the new stock.

The Sinking Fund.

To the eventual repayment of the debt is set an annual sum, called the Sinking Fund. Pitt, as we have seen, concurred in the scheme by which borrowing at simple and accumulating at compound interest was to wipe off the debt almost by magic. Chancellors have learnt wisdom since. Not only can no sinking fund operate by mere mathematical magic, but no sinking fund is safe against the raids of impecunious Chancellors faced with the need for high current revenue.

Under our traditional financial usage the Government is not permitted to carry forward surpluses beyond a small margin in the Exchequer Balance and a small reserve in the Civil Contingency and Treasury Chest Funds. Anything beyond these requirements goes towards repayment of the debt. The two main sums devoted each year to that purpose are the Old and the New Sinking Funds. The Old Sinking Fund takes over the balance of the Exchequer Account as struck at 4 p.m. on 31st March, that balance representing the excess of revenue receipts into the exchequer over issues chargeable to revenue. Under present, and probably temporary, procedure, the balance to Old Sinking Fund is not left to

accumulate until the year-end, but surpluses on the Exchequer Account are issued to redemption of debt forthwith, and are not classified as issues on account of the Old Sinking Fund. The amount shown to that fund is extremely variable, and by arrangement of departmental surpluses—that is amounts underspent by the departments on their various votes—can to some extent be manipulated as from one year to another.

The New Sinking Fund is a permanent and fixed charge. A debt charge is fixed whereby the service of the debt is covered with a margin for the repayment of capital. As the capital is repaid the amount for its repayment will, as a proportion of the charge, automatically increase, since every repayment means less interest to find in the following years and more left for further capital redemption. The amount originally fixed in 1875 for this charge was £28,000,000, but has been altered frequently.

When a new debt was created by the war of 1914–18, the New Sinking Fund was reconsidered, and in 1923 the Finance Act established the "New Sinking Fund, 1923," which in that and subsequent years has had allocated to it sums of from £40,000,000 to £50,000,000. This amount must be issued within the financial year and must be applied within nine months after the date of issue in the purchasing, redeeming, or paying off of debt charged on the Consolidated Fund, other than certain advances from the Bank of England (or the Bank of Ireland) or loans raised under any Act to meet Ways and Means.

Government Brokers.

Both the Old and New Sinking Funds operate in the same general way. Against that part which is to be used

for the redemption of internal debt, the Treasury issues credit to the National Debt Commissioners, who, through a firm of "Government Brokers" buy stock on the open market of the Stock Exchange. This firm operates as any business firm would, not buying merely because the purchase price is available, but waiting for low prices to buy heavily and when prices are high buying little. It will be realized that the operations of the Government brokers in buying stock have a wider effect than that of directly reducing the debt. If, when stock is low, big purchases are made, the stock is supported. This means that the Government credit is hardened. When the price of stock is low, fresh borrowing is expensive, since, if the nominal price of a stock already issued is £100, but its market value only £95, its interest is calculated by the holder on his expenditure in buying his holding. If by buying stock already issued he can get, let us say, £3 each year for every £95 he has spent, he will not buy new stock which shows him a less return. New borrowing must either offer stock with a face value of £100 at £95—with all the ill effects which Lord North's experience displayed to us—or must offer a rate of interest which will be the equivalent of £3 for every £95 spent in purchase. The Government by buying its own stock tends to keep prices up, and thus makes its future task of borrowing so much the cheaper and easier. The stock which it buys is cancelled in the registers.

The debt is subject to other forms of reduction. Patriotic persons sometimes return stock for cancellation from sheer public interest, or death duties are paid in stock which is promptly cancelled, some compounded tax payments are applied to direct reduction and repaid capital advances to the Dominion Governments are also so applied.

" Raids."

In political controversy we hear much of " raids on the Sinking Fund." A Chancellor who is guilty of this expedient when the national income has been over-spent is held up to the execration of the taxpayer, but it is an open question whether anything is bettered by maintaining payments to the fund, and at the same time increasing the debt itself by new issues. Some financial experts argue that the raid is the better way, since not only is there no confusion as to effect on the debt total, but there is an avoidance of the double expense of making the new issue and buying in the old stock. Equally strongly it is held by one school of thought that to provide with each new form of debt an earmarked sinking fund for its special redemption is a weakness, since these special sinking funds cannot be untied when there is a drastic need of money and a wish to avoid creating new debt.

In managing and controlling the debt it will be seen that the Treasury, the Bank, and the Government brokers, work hand in hand for the common purpose. The Bank and the brokers are not State servants, but are in the same relationship to the State as they would be to private customers and clients. There is, however, such a reaction upon both the money market and stock market from the Government's operations, that their active agents in these markets are gifted with unusual power. Whether the Government is under any special moral obligation to the money market in times of crisis has often been hotly argued.

At the time of the Baring crisis, the then Chancellor of the Exchequer refused sturdily to do more than give the weight of his influence to a restoration of the financial equilibrium, and only in very grave times has

the Exchequer permitted a breach of the Bank Act with subsequent statutory protection. The consensus of opinion amongst those most concerned with both national finance and the operations of private financiers on the market is that the use by the State of a bank which is a private institution is safer than and preferable to any proposed nationalized bank which would be but another section of the national executive.

CHAPTER XX

BUDGETS

HAVING glanced at the system of national finance and the cycle through which the financial business of the State passes each year, we may now turn back and, at the danger of some repetition, look more closely at the annual Budget which the Chancellor of the Exchequer presents to Parliament.

The Budget is not—as many members of the general public are apt to suppose—the special and private plaything of the Chancellor of the Exchequer. It is prepared and presented by him for the Government as a whole. One Chancellor, as we have seen, resigned in order to protest more effectually against what he regarded as the extravagances of his colleagues. All Chancellors, we may assume, have fretted at the necessity for giving way before the pressure of other departments. But upon the Chancellor of the Exchequer is the responsibility, and in his hands is the power, of the Budget, upon which the whole legislative work of an administration turns. Behind the Chancellor, exercising in many ways even more power, is the Treasury. From the various departments of State and the Treasury the Chancellor takes his estimates. The House of Commons, as we have seen, will eventually discuss these, but even in the early Autumn, discussions are going forward within the Treasury and the departments as to the amount of money to be allotted to the various services of the Crown. These discussions are ostensibly between the Chancellor and the Ministers of State, but behind each is the Civil Service of the

department. Matters affecting the normal estimates of the civil departments are the subject of interchanges all through the year. It is the estimates of the fighting services and estimates in the civil departments which concern new activities born from new legislation which have to be discussed by the responsible ministers and submitted to the Cabinet as matters of policy and requiring collective approval. At the beginning of October the Treasury issues an Estimates Circular to all departments urging economy and demanding the estimates at a date not later than 31st December or 1st January. With the return of these estimates the preparation of a final estimate —" sketch estimates " having been drawn up earlier as a rough guide—is made possible.

Estimates.

The estimates themselves go before Parliament in February or March. The amount needed for Consolidated Fund services is added to their total. This gives the expenditure for the year which has to be met out of revenue.

While these estimates are being handled the Revenue Departments are sending in returns and reports which show the progress of revenue collection. From these can be approximately estimated the total yield for the year, and from this yield can also be approximately calculated the probable receipts from the same sources for the ensuing year which the Budget is to cover. These figures and the receipts from other sources, such as Crown Lands, interest on Suez Canal shares, Reparations payments, disposals and liquidations, are brought together by the Finance Department of the Treasury.

With the data thus provided, and knowing his intention towards the Sinking Fund, the Chancellor of the Exchequer estimates his surplus or deficiency. He has

certain plans for the introduction of new taxes or the abolition of old taxes or for changed incidences and rates of taxation. These plans require working out in detail. The Treasury, and chiefly the Statistical Office of the Board of Customs and Excise, takes in hand the broad proposals of the Chancellor and calculates what their effect will be. Some yields will be lost. Some will be augmented. New yields will be created. The abolition of an old tax will aid the yield from a new one, or a new tax may react unfavourably upon an existing tax. All these considerations have to be weighed. To some extent the records of previous yields and the history of similar taxes, with the known fluctuations of taxable populations and industrial prosperity, provide a basis of surprisingly accurate calculation. Occasionally it is necessary for the leaders of big industries to be brought into consultation with the Chancellor.

True Requirements.

With the policy implications of his Budget approved by his Cabinet colleagues, and with his calculations provided, the Chancellor of the Exchequer still requires all details with regard to what we may call the true financial requirements of the year. There will be debt maturities, outside the scope of the New Sinking Fund, to be met, which he may decide to meet from revenue or by increasing the Floating Debt, or by new borrowing, or by conversion. There may be capital expenditure of one kind or another to be allowed for.

In framing his Budget the Chancellor of the Exchequer must also watch the necessity of adjusting any changed imposts in such a way that no unfair advantage is given to any sections of traders. Duties must be arranged " as from the " date which may be most convenient from this

point of view. An increase of duty on a commodity or a decrease will cause dealers to buy or sell, to hold or release as the fall of the impost dictates. If it is known before the date of the Budget, for example, that sugar is to have some relief, the sugar market will respond. Secrecy has thus to be carefully observed. If that relief is not made to date retrospectively there may be a gap which will be to the advantage of certain traders and to the disadvantage of others or to the exchequer itself. In the case of customs and excise the Chancellor of the Exchequer may be limited by treaty commitments or considerations of Foreign or Dominion policy.

The day, however, arrives when the Budget is ready for presentation. Until 1913 there was no rule as to when the Budget should be opened. The financial year closed on 31st March, but there might be a long gap between that date and the opening of the new Budget. Pitt introduced a Budget in December. The historic Budget of 1909 was opened, but did not receive the Royal assent until the April of the following year. In 1911 the Budget was opened in May, but the Finance Act was not given the Royal Assent until the middle of December. But since 1913 the Financial Statement has been made between 4th April and 4th May as the result of the passing in that year of the "Provisional Collection of Taxes Act," which lays down that payments or deductions in respect of a temporary tax are legal only within one month after the date of its expiry. As the Income Tax year ends on 5th April, the reaction of this Act upon the date of the Budget will be obvious.

Committee of Ways and Means.

On Budget Day the House of Commons resolves itself into a Committee of Ways and Means. Members, and the

" strangers " in the Press Gallery, have each a Blue Paper which gives the figures of the revenue and expenditure for the past year, and which has blank spaces provided into which the members can enter the corresponding figures for the next period as the Chancellor of the Exchequer announces them. When the Financial Statement has been made the completed Blue Paper is handed in by the Financial Secretary and reappears the same day as a " White Paper " called " Financial Statement—1928–1929," or whatever the year is with which it deals. This statement shows—

1. Tables of the outgo and income for the year just ended, exchequer issues being in comparison with estimated expenditure for the year, and revenue in comparison with both the Budget estimate for the year and the actual revenue for the preceding year.
2. Exchequer balance sheet for the past year.
3. Summary of external and internal debt maturing year by year in the future, and loans to Dominions and Allies.
4. Estimates of revenue for the new year compared with corresponding receipts for the past year on the existing taxation bases.
5. Estimated effect of proposed taxation changes.
6. Balance sheet for the new year.

It is a rule of the House of Commons that nothing can be included in the Finance Bill that is not already covered by a resolution. This means that the financial proposals of the Government which continue taxes imposed only for a year, even if at a changed rate, or which impose or alter other duties, are put in a Ways and Means resolution. In addition to such resolutions a general resolution is passed " that it is expedient to amend the law relating to the National Debt, Customs, and Inland Revenue (including Excise), and to make further provision in connection with finance." The formal resolutions are handed in by the Financial Secretary after the Chancellor's

Budget speech is ended, and the committee, as a rule, passes all but the general resolution at that sitting. On the general resolution is then discussed the whole range of the Budget proposals and policy. No amendment can be moved by a private member which involves an increased charge on the taxpayer.

By the authority of the Provisional Collection of Taxes Act (1913), already mentioned, the imposts are operative from the day following the statement, even if the Finance Act is not yet on the Statute Book—as it never is, unless some other day is mentioned in the resolution, such as the morning of the Budget Day itself. There are certain provisions which guard the taxpayer against undue delay in the passing of the Finance Act after the making of the statement and the passing of the resolution. New taxes not covered by the Act of 1913 are covered by a provision of the Finance Act of 1926.

The Finance Bill.

The Resolutions being agreed to by the House, the "Finance Bill" is ordered to be brought in by the Chairman of Ways and Means, supported by the two Treasury Ministers, and is read a first time and ordered to be printed. On the Second Reading of the bill the Government's general proposals are again debated. The bill then goes through all the usual stages of a Parliamentary Measure so far as the Commons are concerned with it, and in committee stage and on report stage is discussed in detail, pending Third Reading, when again the policy of its sponsors is discussed generally. But any money resolutions which involve charges must be taken in a committee of the whole House before the corresponding provisions of the bill can be taken. The clauses requiring money resolutions are not technically part of the bill

and are printed in italics. If the necessary resolutions have not been passed before that stage of the bill is reached in committee, the clause is struck out and re-inserted by moving it as a new clause after the necessary resolution has been obtained. Any taxation proposals which are outside the scope of Ways and Means resolutions as originally taken must also be covered by new Ways and Means resolutions before they can be taken in committee stage.

This somewhat complicated procedure, it will be realized, all protects the rights of the Commons to exercise close and rigid control over the finances of the nation.

When the Finance Bill goes forward to the House of Lords it is covered by the provisions of the Parliament Act of 1911, which lays down that if a public bill certified by the Speaker of the House of Commons as a Money Bill within the meaning of the Act, having been passed by the House of Commons, and sent up to the House of Lords at least one month before the end of the Session, is not passed by the House of Lords without amendment within one month after it is so sent up to that House, it shall (unless the House of Commons otherwise direct) be presented to His Majesty and become an Act of Parliament on the Royal Assent being signified, notwithstanding that the House of Lords have not consented to the bill. It must be borne in mind that the Speaker may not certify the Finance Bill as a Money Bill within the meaning of the Act—and some war time Finance Bills were not so certified—in which event the House of Lords treat it as an ordinary measure. In any event, on the Second Reading in the Upper House it is customary to raise questions of wide general interest, such as Imperial Preference, or national economy, or admission of aliens, which may be affected by the financial policy of the Government.

§ 2

We cannot in the scope of this present work examine in detail representative Budgets, but the student of national finance will find that certain of them are of especial importance to an understanding of the progress of our financial system. That of Pitt in 1784, with its attempt to simplify and purify financial practice, and his Budget of 1798, wherein he introduced the income-tax, we have already glanced at. The reintroduction of the income-tax by Peel in the Budget of 1842 gives that year an importance. This Budget, indeed, is one of the most famous of the long series of that century, for Peel, in the words of his most recent biographer, Dr. Ramsay, "at one stroke converted a deficit into a surplus, carried a sweeping measure of tariff reform, and laid the foundations of a new system of taxation." Three years after, in 1845, the year following the Bank Charter Act, he introduced a Budget hardly less important, in which of the 813 articles on the tariff he struck off 430, abolished the coal export duty, the duties on auctions, cotton wool, and glass, and lowered the sugar duties by a further reduction of 10s. on that of the previous year, paying for the consequent loss of revenue by a renewal of the income-tax for three years. These two Budgets, as we now see, paved the way to the repeal of the corn laws in 1846, and knowing to what change in social development and political positioning they led, we, wise after the event, may read them with more than an abstract financial interest.

Death Duties.

The whole range of the Gladstone Budgets from 1859 to 1865 repays study, and Sir William Harcourt's Budget

of 1894 is of unusual significance. It contained his device for providing means of expansion to the Army and Navy estimates without further additions to the income-tax, which he regarded as a fiscal reserve against war. That device took the shape of the new Death Duties, which, within the past two decades, either deliberately or unwittingly, have been used as a means of readjusting social wealth between classes, and have thus assumed importance quite beyond their financial aspect.

We can leave for students of taxation, as such, the fate of the graduated income-tax, and the death duties, through the present century, with the observation that the famous—or, according to the point of view, infamous—" People's Budget " of 1909, its immediate predecessor and almost all that followed it up to 1914, continued the work, blandly, but unsuspectingly, inaugurated by Harcourt, of using financial means for the reform, redress, or disruption of social orders. (I write without passion or prejudice. It may or may not have been wise and needful that policy should have followed the lines it did follow. The then Chancellor of the Exchequer may have been an incarnation of Saint George or of Lucifer. All that concerns me at this moment is to reiterate that the Budget of 1909, containing provisions recommended by their virtue in making things unpleasant for certain members of the community and used to force a constitutional issue with the Upper House, marks a departure in national finance, which must be studied.) The developments following 1909 were interrupted by the eleven war Budgets—November, 1914, being the date of the first, and 29th of April, 1924, being the date of the last of the series—and with the first Churchill Budget (28th April, 1925) we enter a new series culminating in the Budgets of 1928-9, which inaugurated

the sweeping measures of Local Government Reform attached to what is known as the de-rating policy. The financial expedients of the Budget of 1927, following the coal stoppage and subvention, and the General Strike of 1926, should be studied as examples of extreme ingenuity in avoiding fresh imposts after unexpected calls upon revenue and unexpected diminutions of yield.

§ 3

We have already observed that a Budget may contain means of financing social or other reforms agreed upon as parts of the policy of the political party which is in power, or that it may apply financial provisions in such a way as to compel social relationships to reform themselves. If it is part of my policy to encourage tenant farmers to become landlords I must find the means of supplying them with the necessary credit and finance for land purchase. If I tax land beyond the capacity of the present owners to pay, I drive great landlords out of existence and may, quite incidentally, create a race of small owner-farmers, but I have not in this case merely applied finance to the policy of creating such farmer-owners: I have applied financial measures designed for quite another purpose. My tax on land might have been imposed in order to finance a scheme for public playing-grounds, or a big navy, or half a dozen other ends. As we have noticed, the Harcourt death duties were by no means intended to adjust drastically the national possession of great estates, but to prevent a rise in the income-tax for the purpose of finding money for a naval programme.

Several considerations, then, must affect one's judgment of a new tax or an increase in the rate of an old tax. Not only must it fulfil the canons laid down in Chapter

XVIII, but its political effect must be such that it can clearly be envisaged. A tax with reactions not intended by the imposer is a bad tax, and the levier of such a tax is not only an inept statesman but a bad financier. A Budget which leaves industry unsettled, or which confronts industry with the knowledge that its earning power is to be hampered and its progress impeded, may balance to a farthing with the estimates, but it is none the less a bad Budget.

The State and Industry.

It must always be remembered that any money diverted to the State is diverted from industry. If the State uses the money more fruitfully in the creation of new wealth than industry would have used it, the diversion would not be ill; but whereas industry exists for the specific purpose of increasing wealth, and the State does not, such diversion in actual practice is never good. In the political jargon of our day we hear much of the parasitical units of the community. From the narrow view of industry the State is parasitical whenever its activities are not essential. As the guarder of the territorial integrity of the island, as the keeper of law and order, and the enforcer of contracts, as the provider of the agreed communal services, the State is a contributing partner. But very few, indeed, of its activities impose other than an unredeemed overhead cost upon the industry of the community. This being so, any diversion of money to the State should be computed as a double loss to the community, for not only is there a disappearance of the money paid into the coffers of the State, but there is a disappearance of the otherwise potential profits from the use of that money.

It will be argued that the money is quickly paid out of

the coffers of the State, and returns to communal employment. So, indeed, it does, but the delay in the process of its fruitful application is expensive in terms of real wealth, and very often the expenditure of it by the State is definitely unproductive, as it was on the warship *Clampherdown*, which

> *. . . carried a million pounds in steel,*
> *To the cod and the corpse-fed conger-eel,*
> *And the scour of the Channel tide.*

These points are all commonplaces, but the effect of National finance upon both industry and the private citizen is immediate no less than postponed, and a Budget which is so framed that it either involves the community in inconvenience or diverts unnecessarily the stream of wealth from fruitful to unfruitful ground may, by the inadvertence or ineptitude of its framer, cause as much social resentment and political unrest as a Budget maliciously framed deliberately to inconvenience selected social classes, and may, by the unsuspected reactions of its finance, cause ills as grave as any remedied by the social reforms which it makes possible.

CHAPTER XXI

THE FISCAL CONTROVERSY

Our examination of the system of national finance revealed the existence of revenue departments, which included those devoted to the collection of customs and excise duties. Without, as I trust, over-stepping the border-line between finance and politics, I now propose to direct some little attention to the controversy which for over a century has raged over that section of our financial machinery. For a detailed exposition of the nature and scope of the duties which are collected by the departments concerned with customs and excise duties the reader must look elsewhere, but as a simple definition he may remember that the **customs** are duties imposed on imports and exports, whereas **excise** duties and licences are imposed upon certain home commodities.

The United Kingdom exists under a system known as that of Free Trade or Free Imports. Either name is a misnomer. The State does, as we have just seen, impose certain duties on some of its imports and some of its exports. Neither in its trade nor in its importing is the community quite free. But the duties, compared with those levied by States not living under the Free Imports system, are relatively slight, and are imposed for revenue only.

Duties on Imports.

Duties upon imports levied for purposes other than the raising of revenue are said to be Protective Duties. They protect the workers of the importing country from the

competition in his home market of the products of foreign workers.

It will be seen that the imports most suitable for a revenue duty are those which are not grown or manufactured in the importing country, while the imports most suitable for a protective duty are those which are grown or manufactured in the importing country. Where a commodity is subjected to a duty and comes in great bulk from abroad with a small bulk produced at home, it is usual to levy a customs duty on the imports and an excise duty on the home-produced, thus ensuring that all consumers of that commodity contribute to the revenue.

If the duty have a second purpose, that of giving to the home-produced commodity an advantage, the customs duty is not paralleled by an excise duty. Similarly, a customs duty may be varied as between one source and another. If a revenue duty is placed upon wine, and is lower on Empire wine than upon European wine, the favoured commodity is said to enjoy a **Preference.** But once a duty on imports is not paralleled by an excise duty, or once it is varied to give a preference, the duty, even though still ostensibly levied for revenue only, is protective in its operation.

Those who believe that any particular nation will flourish most without any restrictions upon its imports and exports are called Free Traders. Those who believe that a particular nation will flourish most with a system of duties which eliminates in its own markets the competition of foreign producers are known as Protectionists. Their differences of opinion, which, as I have said, have troubled the political life of Great Britain for over a hundred years, show no promise of ever ceasing to perturb the public mind.

Free Trade.

World free trade—let it be dogmatically said—would be the ideal system for the human race. To this both Free Traders and Protectionists agree. World free trade means trade between all men and all nations unhampered by any artificial restrictions of exchange. The lands and communities most suited by nature to produce certain commodities would produce those commodities, the inference being that so would arise the maximum efficiency of production. Once produced, these commodities would be freely exchanged. But let one artificiality intrude, no matter of what kind, and world free trade is impossible. If I have a slave and my neighbour have none, if I have a debased currency and my neighbour have a just currency, if the workers of one nation are driven to work in inexpensive conditions and those of another are not permitted to work in other than expensive conditions, if only one small section of the smallest community prohibits the free exchange of the least important commodity—then world free trade is from that moment impossible.

Recognizing the force of the argument in the above paragraph, it is still logical to hold that a country will be better off if it is allowed to import whatever it may desire from whomever it may choose to patronize, than if it is subject to restrictions. If the secret of success be to buy in the cheapest and sell in the dearest market, then cheap foreign imports, whatever their condition of origin, are aids to success. The Free Trade standpoint sees cheap imports as an essential condition to national prosperity. To apply the finances of the nation in such a way as to raise the cost of materials is, in this view, to wreak a mischief on the national life. Even revenue duties are bad, and protective duties would be fatal. If the foreign worker can produce and market here "Commodity A" more

cheaply than the home worker can produce and market it, let the foreigner do so, and the English worker can turn his attention to making and marketing " Commodity B," to which both he and his conditions are adapted. As an economic principle it has become axiomatic that freedom of exchange tends to produce a maximum of wealth in the area to which it applies, and if that area be inclusive of ourselves and the foreign workers, we must all benefit eventually by the wealth created. If we refuse to import from the foreigner, we prevent him from effecting a further exchange after our transaction, and, as that further exchange will be but one of a series, we are preventing someone from eventually buying from us.

Such, in extreme brevity, is the Free Traders' standpoint.

Protection.

The Protectionist argues as an empiricist. He knows that the nation has a certain section of its people working on the production of " Commodity A." He knows that if the import of that commodity is allowed those people will be thrown from their employment. He does not *know* that an alternative employment on the production of " Commodity B " can be found for them, and, he does know that, even if it can be found, there will be an awkward transition period. During that transition period the displaced workers will have to be supported, and some may for their lives demand support without giving further work, since the humane ethic of our civilization forbids the State to drive them into lethal chambers or to place them against a wall and have them shot by the soldiery. This being so, argues the Protectionist, it will prove more profitable in the long run to protect them from the worklessness produced by unlimited and competitive

imports than to strain the finances of the State in providing them with means of migration to new industries or means of subsistence if no new industry be found to support them. In other words, it may prove better to allow the community to pay a slightly higher price for certain commodities and keep its units employed, than to pay a lower price for those commodities but make a higher contribution to the State. And, continues the Protectionist, does Protection necessarily mean a higher price? It is true that the first result of a Protective tariff should be either to keep out the cheaper article or to cause it to pay a duty which will bring its price to the home level. But the home level is determined by the unit average of home-produced articles on a basis of production as determined by sales, and those sales are at present governed by the foreign competition. Eliminate that competition and the unit average over the widened basis will bring down the home cost.

Mr. Belloc, a Free Trader, has succinctly put the Protectionist case in his *Economics for Helen*, where he writes:

> "We have seen that the following formula is true: Freedom of exchange tends to increase the total amount of wealth of all that area which it covers. But what gives the argument for Protection, in special cases, its value is a second formula, equally true. Though freedom of exchange tends to increase the total wealth of an area over which it extends, yet it does not tend to increase the wealth of every part of that area. Therefore, if a part of the area over which freedom of exchange extends finds itself impoverished by the process, it may be enriched by interfering with freedom of exchange over the boundaries of its own special part."

On such lines does the Protectionist case develop.

Safeguarding.

There has arisen a mid-way policy which suggests that only where foreign competition is abnormal, where the

home efficiency is proven to be efficient, and where there is a specific demand for a safeguard from that competition, granted after careful examination, shall a duty be imposed on the import. That policy is known as the policy of Safeguarding. It permits abnormal duties to meet abnormal competition, to selected applicant industries, but does not propose to apply any general protective system of tariffs.

We cannot enter into the controversy on its political side, but the student of such matters will find no lack of literature at his disposal when he desires to pursue his quest for fiscal wisdom. He may, however, as a student of national finance, note that the motives behind the advocacy of fiscal reform are not immediately financial. Protective tariffs are not designed to raise high direct revenue, but to Protect—that is, to keep out the imports upon which they are levied. Revenue duties, conversely, fail in their object if they severely lessen the inflow of the commodity upon which they fall. Any protective duty, unless it be preposterously high, will undoubtedly produce a certain amount of revenue. Some people will buy protected articles irrespective of their comparative cost, and the duty will be paid to gratify the will to possess them. If the contention of Protectionists be sound, protective duties will increase the total revenue yield of the nation, since the producers will be aided towards increased prosperity thereby. If the contention of the Free Traders be sound, protective duties will decrease the general yield, since restricted imports must lower the general prosperity of the nation. But increase or decrease of total yield as a secondary financial effect of one policy or the other is really only the financial aspect of the stimulus given or taken from industry by that policy. No student of the fiscal system is an advocate of free trade or tariff reform *qua* financier, but *qua* economist or industrialist.

CHAPTER XXII

ECONOMICS AND FINANCE

IN the earliest chapters of this book there emerged from our discussions of finance certain elementary facts and deductions familiar to all students of economics. Having now, however superficially, explored the general ground of financial theory and practice, we may return to a consideration of these and other aspects of economics, in the hope of deriving from them some illumination upon whatever information and knowledge we have gathered. We may also conveniently sum up and re-apply some of our conclusions.

Every citizen, we may say, is, wittingly or unwittingly, at once a capitalizer, a consumer, and a worker. (I use the ugly word capitalizer because capitalist has attached to itself a special meaning, involving the conscious use of capital.) He has to manage his own finances, and his management affects the finances of all his fellows. He has to contribute to the finances of the community in which he lives. He is equally affected by the manner in which his fellows manage their finances or in which the State manages the communal finances.

In one form or another the citizen takes his wages from the community. He may call the series of exchanges which he effects, as between his own services and products and the services and products he receives, his wages, his pay, his income, or whatever be the term applied in his particular class of the population. We have seen that the use of money as a measurement of value as well as a medium of exchange may confuse the mind as to the

precise economic changes which occur in the values so measured. An apparent rise of prices may only be a fall in the general value of money. If, for example, in 1909 I could buy a suit of clothes for 4 guineas and could sell a newspaper article 4,000 words long for the same sum, the arbitrary exchange value of my article was a suit of clothes or £4 4s., or any other service or commodity or mixture of service and commodity priced at that sum. If in 1929 I can still buy a suit of exactly the same quality, but have to pay for it 8 guineas, while my 4,000 word article also brings me twice the price of 1909, the exchange value of the two has not altered, but money has obviously fallen to half its earlier value. If, however, in 1929 the suit costs me 8 guineas and my article only fetches 4 guineas, one of two changes may have taken place. The value of my writings may have fallen with the value of money, and the value of the suit remained unchanged as against other exchanges. Or the value of my article and money may have remained unchanged, while the value of the suit has risen.

Psychological Vagaries.

If the citizen finds that his wages have doubled in nominal amount—that is, if he now draws £10 a week instead of £5—but that the value of money has fallen by exactly one-half—the level of exchange values apart from money being unchanged, he is, apparently, neither better nor worse off than he was before the rise in his pay. Actually he may be worse off, because owing to a mental confusion in the social value of money the receipt of more of the standard coins of his community may lead him into new forms of expenditure. High nominal wages are a greater temptation to spend than low nominal wages, *if the recipients have ever known a period of low*

nominal wages against which to compare their apparently increased affluence. As a demonstration of the psychological effect of a mere multiplicity of coins I may cite the frequent expression of opinion that " no sooner do I break into a £1 note than it seems to disappear." We have all, I suppose, both heard and uttered this plaintive wail. There is no economic reason why 20s. should appear to go quicker than a £1 note, but we all know, as frail uneconomic human beings, that such is their tendency. The curious student will be able to divine the real reason from the chapters devoted to currency in the first part of this book.

At this point we must distinguish, as many orthodox economists do not, between an increase in the wealth of a community and an increase in the general prosperity of its units. It is difficult, and, as far as I am aware, as yet impossible, to arrive at any exact relationship between money spent and wealth consumed. The wealth of a community obviously depends upon the balance of two factors, the amount of wealth possessed and created and the amount consumed. When the worker takes £1 of his wages and spends it he usually consumes a very small proportion of actual wealth. If he buy a packet of cigarettes, for example, he pays for a small amount of tobacco leaf, a small amount of cardboard and silver paper, a small amount of other paper, a share of the wear and tear on machinery, ships, warehouses, and the other objects affected by the making and selling of cigarettes. But most of his money pays for services rendered to him by other workers and by the State. Similarly, if he go to a cup-tie, the money he spends is almost all spent on exchanged services. True he carries an infinitesimal share of the wealth consumed by the players, and of the wear and tear on their garments, and on the various

objects necessary to the contest. Even if he buy edibles with his money he does not consume much real wealth, for his direct consumption, say of sausage, is small and the indirect consumption of those who made the sausage, from the farmer raising the pig to the shop assistant who passes the parcel over the counter, is also small. Most of his money is paid for services. Some expenditures actually cause no detectable increased consumption. The cup-tie would be played if a hundred fewer spectators were present, and the expenditure of some of the spectators thus does not affect the consumption of real wealth.

If the various members of the community exchange their services freely—that is, if they spend their money freely—without appreciably increasing the consumption of real wealth, that community will enjoy prosperity in the common use of the word, but it may be actually decreasing slightly for the time its stock of real wealth. If, for example, the clothiers have over-stocked their warehouses with clothes which none will buy, the communal stock of wealth is increased by the amount of garments. But if, by a sudden wave of expenditure, the clothes are bought—the actual consumption of true wealth in the wearing of a suit of clothes, let it be remembered, is not great compared with the relative money value of the exchanged services—and the circle of production and consumption re-started, the stock of clothes may decrease but the general prosperity of the community will rise.

High Wages a Stimulant.

Such a wave of expenditure may be caused by high nominal wages mistaken for high real wages. It may be caused by the raising of the level of real wages. The community would *not* be in the same position if on a given pay-day all wages were doubled and all prices doubled,

for the psychological effect of the change would be to stimulate consumption, which would in turn stimulate production, which would lower the unit average cost at which articles could be produced, again stimulating consumption. From this point of view high wages are a definite stimulant to prosperity.

But, since the labour cost is an important item in costing production, the higher the wages paid the dearer must be the price at which the product is marketed. And since State imposts are levied on totals, the heavier must be the amount paid to the State. Therefore, from this point of view the lower the wages the greater the prosperity of the enterprise, since low selling costs mean greater consumption, other things being equal. In other words, low wages mean a low cost of living and high wages mean a high cost of living. How are the two points of view to be reconciled? And how, it may be asked, does the dilemma affect the study of finance, which is all that strictly concerns us at this moment?

If we double the nominal value of wages, we have obviously depreciated the exchange value of the currency in which they are paid. If at the same time we have halved the exchange value of the standard metal behind our currency, we have not, strictly speaking, depreciated our currency, but we have doubled the gold price of every consumable article and purchasable service.

But in practical life we cannot, and do not, ensure that any change in either real or nominal wages will be universal and simultaneous. If the engineers manage to extract from their industry a rise in real wages they have actually managed to have placed on their services a higher exchange value. That, from the view point of the persons with whom they exchange, means that every one else *vis-a-vis* engineering has suffered a lowering

of his exchange value. In due course efforts are made by the persons affected to have their own real wages increased. When all affected have achieved that object none has benefited except by the benefit felt in the interval of adjustment, and none has suffered except by the deprivations in the same interval. But so complicated is the series of exchanges that there will inevitably be some who cannot manage to have their real wages brought to the new level. They will continue to suffer. Or it may be that one grade of worker will find his real wages permanently higher than those of the other grades, and he will seem permanently to benefit. If, however, the margin of apparent permanent benefit be such as to make his product unmarketable—if the exchange value set on the services of the producer make the product of an arbitrary value which does not invite or permit exchange —he will eventually suffer, for his services will fall out of demand.

"Dumping."

It will be clear from the mere sketching of the complications which arise that the battle between high wages and low wages cannot be decided on any one ground. Those complications become further involved when there is taken into consideration the fact that the market price level of the products affected by changes in wage levels is determined by the competitive offers of similar products manufactured by communities on other and different levels, and that this factor is itself affected by the further complications of the dumping into competitive markets of surplus units of production. (If by turning out 10,000 units of my product I can bring the cost of each unit down on the average to a price which will command a huge home market and show me a profit on the sale of 9,000

of those units, I can afford to "dump" 1,000 units in some foreign market at or below cost in order to keep my productivity up or to embarrass my foreign competitors.) But it may be generally said that high wages do stimulate circulation of money, and a stimulated circulation means also a stimulation of consumption. As consumption is, in fact, more a call upon services than a true consumption of commodities, the greater the consumption the wealthier the community tends to become. Behold, I show you a mystery! But the paradox has been frequently proved true.

I have said that every citizen is, wittingly or unwittingly, a capitalizer. Let me now elaborate that a little. Hiram Blenkinsop is a thrifty clerk in the Midlands. Jehu Jackson is a thriftless clerk in London. Hiram and Jehu draw each the magnificent stipend of £4 a week. Hiram, living at home with his old mother and having no hobbies beyond the cultivation of a small patch of allotment and the cultivation of his spiritual ego in the neighbouring Salem Chapel, manages to save £50 every year. That £50 he invests in whatever enterprises appeal to his cautious nature. Jehu, sharing diggings with a fellow clerk, wastes his substance on riotous living in the local billiards hall, the local hostelry, and the local cinema. He saves nothing, and is, in fact, usually a trifle behind with his rent and his boot-repairer's bill. But most of the money which Jehu spends in these riotous amusements of his goes, as we have seen, to persons who merely render him service. Very little of it passes in exchange for genuine wealth which he consumes. Those persons in turn find a use for the money which he passes to them, and some of them will apply it exactly as Hiram applies his savings, they will invest it. It may be, by a chain of exchanges, that Jehu's thoughtless expenditure

actually helps to provide the salary of Hiram, and that Hiram's investment may help to keep Jehu employed, so that Jehu by wasting his money in "The Stag and Steeple"—that cosy tavern—is actually helping to ensure his own continued employment.

From the viewpoint of the financier it matters little whether new capital is provided directly by Hiram and Jehu, or directly by Hiram and only indirectly by Jehu. The workings of economic providence to him are inscrutable, and the thriftiness of the one is in the event no more valuable than the thriftlessness of the other. In fact, much as it may distress him as a moralist and a sociologist, he derives, perhaps, more benefit from Jehu than from Hiram, since Jehu and his tastes—multiplied, of course, by many thousands of other Jehus—open the way for new forms of production, whereas Hiram only provides the means for old forms of production or for the new forms of production created by the social tastes of Jehu.

Effect of Thrift.

The effects of thrift are twofold. Thrift allows capital to accumulate, but it also lessens the demand for capital. The effects of thriftlessness are likewise twofold. It allows capital to accumulate, by letting it drift to the thrifty, who will hold it in its flight, and it strengthens the demand for capital, since the demands of the thriftless for their follies become calls on capital for the provisions of satisfactions.

If this excursion into the paradoxes and bewilderments of economics displays anything of value for us, it is that when the financier calls upon capital he calls upon no actual pool of wealth. He calls upon a series of small individual pools and upon the flowing stream which is

circulating between those small pools and between units of society who have neither the wit, the energy, nor the desire to dam it as it passes them. Having diverted capital from its flow to his particular purpose he does not lessen the volume of the stream nor the capacity of the individual user to accumulate a fresh pool which will be again diverted when the moment is ripe. When, therefore, any social reformer talks lightly of taxing the pool of capital, he talks of taxing something which does not exist. All he can hope to do is to divert in a fresh direction the general stream of capital, preventing, perhaps, the thrifty from making the small dams which will aid the present directors of the stream in their task of diverting the flow to some new and fruitful industrial ground, or preventing the thriftless from assisting in the circulation of the stream by preventing them from satisfying their desires for this or that form of service from the community. He may, of course, divert the stream to uses more profitable than those from which he deflects it. That is a matter for him and his fellow social reformers to argue. We may, without prejudice, remark that, prima facie, it would seem that the business of capital irrigation will be more successfully performed by skilled productive irrigationists than by amateurs who may prefer to water the flower gardens rather than the kitchen garden, from whence comes the subsistence of the population.

The community, as a community, can obviously become thrifty in one of two ways, by the cultivation of the habit of thrift in individual units of the population and by the prevention of certain expenditures by State action, such as taxation which leaves no person margin for such spending. Either method will cause capital to aggregate in usable quantities. But the first method

will leave the aggregations fluid, whereas the second method will tend to make them restricted in their application. The first method will give an elasticity to finance which the second method prohibits. If there is a call to finance a new venture in industry, say the exploitation of an invention before the demand for that invention has become articulate, a vast congregation of thrifty persons may be willing to respond, since they risk only their own money. But centralized finance, say under some new kind of bureaucratic State, could not so readily respond, since the bureaucrats controlling the money might, for one of a dozen reasons, prefer that the new invention should not be developed, and since persons responsible for the using of money gathered from others to whom its use is accountable cannot take the risks possible to free agents.

The private control of finance is sufficient demonstration of this truth. The modern Investment Trusts, some of which courageously depart from the rigid conventions of conservative investment, represent a centralizing of private thrift. They neither respond to adventurous enterprises as would many of the individual capital providers who hold their shares, nor do they stimulate capital exchanges as would the unrestricted movements of their shareholders acting as units. Bureaucratized finance would exaggerate the caution of the Investment Trust into a timidity which would paralyze industrial adventure.

The Financier's Range.

If there existed—as, we may thank Providence, there does not exist—a species of man who was interested in nothing but finance for its own sake, whose self-appointed task was to watch that " secret river of gold," he would

not be the dry and arid person into whom men of a single interest usually develop, for mastery of finance implies knowledge of all changes, tendencies and developments in the social, economic, and political lives of all nations, and whether he conceived his own work to be that of adapting the control of finance to the fluctuating relationships of mankind as they changed under his observation, or that of himself affecting those relationships by the application of his financial resources and knowledge, he would still require a range of knowledge wider than that of his fellow men. Absurd as it may sound, to the financier it is equally of interest that American collectors are buying the first editions of modern poets at inflated prices as that American politicians are pressing for a new tariff; that skirts are to be worn shorter next season as that a general strike may occur in the Spring.

These things vary in importance, but they are all factors. Especially significant are the indications of changes in the habits of the people, the growth or decay of thrift, the rise or decline of the bureaucratic control, the dominance or repression of one type of statesman or another. To the financier who is merely avaricious, all things can be turned to advantage. Whether kingdoms wax or wane, the watchful manipulator of finance must benefit if he cares to make someone's extremity his opportunity. To the financier who conceives his function to be greater than that of an accumulator of high personal rewards, the study and application of finance is but another method of applying statecraft to the affairs of a community. To such a one, then, the clarification of economic problems is a vital prelude to activity. Private thrift and public prodigality must to him be more than regrettable or foolish exhibitions of human strength or weakness. They must be ponderable factors in his

general equation. He who wishes to advance from a broad general understanding of financial principles and practice to a mastery of the science of finance must, therefore, prepare himself for a devotion to economics and sociology. But, lest that prove frightening, let me say hastily that such devotion demands no absorption in dry official textbooks. It is the fate of the practical man to discover in middle life that, just as M. Jourdain discovered he had been talking prose all his life without knowing it, he has been mastering both the dry sciences without realizing it.

CHAPTER XXIII

INCENTIVES TO CONSUMPTION AND PRODUCTION

WE have seen in those chapters devoted to credit and to banking how there evolved the system of credits for production. A credit for production is actually applied also to consumption, since the preliminaries of production involve the consumption of certain commodities, either as raw material or as accessory facilities. But production once well advanced, there must be some eventual consumption of the actual product before the economic circle is complete. When the bank takes my deposit and lends it to a producer it assists the production of the article to be sold in advance of the purchaser's readiness to purchase or, at least, to pay for his purchase. If my bank grants to me a small overdraft on my personal account it reverses that process, and assists the consumption of the article before the consumer is ready to pay for it. Similarly, if my tailor allows me twelve month's credit it is the consumption which is aided.

Consumer Credit.

Consumer credit has always played a large part in our social and economic scheme, but recent years have seen an unlooked-for development in its scope. Just as the creation of small denominational shares created new investors and new speculators by permitting men of small means to participate in the opportunities hitherto reserved for men of larger means, so new methods of extending credit to consumers have permitted the man of small means to enjoy the facilities of his wealthier brother.

When credits granted for production lacked at the other end of the series of exchanges a consumer, they became frozen. How to thaw these credits occupied for many years the minds of able industrialists. A method was discovered in the extension of what twenty years ago was known as the hire-purchase system. Under this system a customer hired an article from the retailer and after an agreed period of hire the article became his. The terms of hire were adjusted in such a way that the vendor was compensated for losing the value of the article which would have been returned to him at the end of that period had the hire been simple hire, and also for the potential profit he might have had from continued hire over the usable life of the article. The hire-purchase system found a new development in "the instalment system," whereby the agreed price of a purchased article instead of being paid over immediately by the purchaser was paid in agreed instalments, the vendor again protecting himself against the loss to him occasioned by the holding up of his money over the agreed period of the instalments.

Writing at a time when the advertisements for goods under either of these systems confront the wayfarer at every turn, I need not stress the rapidity of the development of the two systems in Great Britain, and the earlier and more rapid development in the United States of America.

Pros and Cons.

The spread of the social habit of buying goods under a system of delayed payments was regarded—and is still regarded—by many orthodox economists as a definite ill. The process was said to consist in pawning future production, and in tempting consumers to purchase more than they were justified in doing by their actual

capacity to pay. The consumers themselves were regarded and, perhaps, rightly, as anticipating without wisdom their future incomes, shackling their future needs by a too precipitate gratification of present desires, and allowing themselves to pay interest on the money provided for their accommodation far in excess of the ruling rates for such accommodation.

It was also held that the successful practice of the system for a long period was no criterion of its eventual capacity to sustain itself. Although the people who financed the consumer credits might say that over such a period their losses amounted to only one-tenth of 1 per cent, should there come an industrial " slump " the purchasers would find themselves unable to continue their payments, and damaged goods would be returned in vast and unsaleable quantities to the vendors, with disastrous results to all concerned in the evil game.

Against these arguments were brought the facts, as ascertained by those operating the system, and the argument that a similar system applied to certain commodities had always been approved. Houses bought by instalments had been the favourite investment of certain classes of the community, whose activities as property acquirers in this way had been universally commended by the most conservative and orthodox economists. Not only did a consumer credit bring the necessary complement to a producer credit, but it enabled the user to live life on a more civilized scale. Production was released from stagnation thereby, and the general level of happiness raised.

What Actually Happens.

It is of interest to note what actually happens when a purchase is made on the instalment system. A sum is

paid over for the use of the article for an agreed period. A second sum is paid for its use over the second period, and so on, until the purchase is completed. At no time has the purchaser committed himself to a future expenditure which he may not be able to meet, since he has but to relinquish the article and his responsibility is ended. To acquire the article by some other means he would have had to save his money, and forgo the use of the coveted possession until the full amount was saved, or to have borrowed the money, or to have purchased the article and taken ordinary credit until his money was saved.

It may be asked why should the producer await a sale until the amount is saved when by a simple arrangement it can be expedited to the mutual benefit of both parties to the transaction, or why should it be economically sound to borrow the money from one source and not from another, or allowable to take full and extended credit and not to take partial credit?

Contingent Demands.

Another argument against the consumer credit system is that it gives a false perspective to the producers, who, by anticipating contingent demand, provide means for its satisfaction which will have no employment once the satisfaction is complete. This argument is somewhat weakened by the fact that as one set of contingent demands is satisfied another set is created in the same purchasers. A house of furniture is so bought, and when all the instalments have been met, a motor-car is next added to the domestic possessions, and so on. Also new generations of wage earners arise who will take advantage of the system. The once popular music-hall song—as all such songs, a sure guide to the social outlook of the

masses—which caused a young man to announce the gratifying fact that—

> " . . . My girl's promised to marry me
> When I've a hundred pounds,"

would be without savour to the present generation, which would refuse to wait for the accumulation of this sum at small simple interest in a savings bank, and would furnish out of income over a period of three or four years.

An argument in favour of the system which seems to counter the false basis of production is that by consumer credits demand is so stimulated that factories can achieve a mass production with all its concomitant economies, thus lowering selling prices and again stimulating by secondary effect the consumption already stimulated by primary effect. To reduce prices without lessening trade activity is tantamount to enjoying all the advantages of deflation without losing any of the advantages of inflation.

Whatever the balance of advantages as shown by the arguments marshalled for and against the system, the system persists, and it is used increasingly by small income drawers. The small local trader may complain that his suburban customers leave his bills unpaid while they meet the instalment on the gramophone or the motor-car, and the maker of sound furniture may declare, rightly or wrongly, that under the system people are induced to buy shoddy stuff at high prices. These complaints matter not to the masses. The system has met a need and is being gratefully used.

Financing the Trader,

But it is clear that a manufacturer or retailer of some commodities cannot himself give extended credit on the instalment plan to a sudden rush of new customers. He must find someone to finance him. His need has given a

stimulus to finance houses, and it is the rule that the purchaser who buys goods on this system does not actually pay the person who supplies them. It was an obvious safeguard that the financing of trade on such terms should be distinct from the business of merchandising. The specialist engaged in the work of making or marketing could not hope to be a specialist in the business of granting and controlling credits. The finance of hire purchase is a special branch of finance. There are unusual risks to be allowed for, and the falling in of portions of interest and capital at short periods involves special calculations of the exact interest which is being taken. If I buy goods worth £100 for spot cash, and propose to take a year's credit for them, paying the vendor £108, he has charged me 8 per cent. But if he assumes 8 per cent and divides £108 into twelve monthly instalments of £9, he is taking far, far more than the agreed percentage, since at the end of the first period he has the use of my first instalment, and so on through the year.

The money which the finance houses engaged in this class of business apply to the system is, apart from their own capital, generally acquired from the Money Market and the banks. They are corporations pursuing a special kind of banking business.

There are certain developments of the consumer credit system which are not good. Traders carrying their own risks, or corporations founded by a manufacturer to finance his own transactions, represent dubious units in the financial system. The habit of manufacturing a special and specious kind of article for the instalment market, and the too ready credits offered to ingenuous purchasers are also bad, since the one artificially complicates values and destroys taste, and the other invites, instead of avoids, bad debts.

§ 2

In arranging for the sale of goods under a hire-purchase agreement the merchant has to adapt what is a new method of sale to a general trading system governed by statutes and usages which were framed before any such method as consumer credit had been envisaged. He can, with perfect freedom, sell his goods to a customer on what terms he chooses, and on a failure to receive payment may re-possess himself of those goods. But his position *vis-a-vis* the third party who gives him financial assistance in the transaction is not so clearly defined. As Mr. J. Gibson Jarvie, our greatest practical authority on hire purchase, has frequently pointed out in speaking on the subject, the merchant will find his hire-purchase agreements regarded by his bank as a doubtful security. "He cannot," says Mr. Jarvie, "assign to his banker his proprietary rights in the merchandise. Under the Bills of Sale Acts in England a mortgage cannot be created on movable merchandise without registration, and no person in England, whose credit is worth anything at all, would ever consent to the registration of a Bill of Sale on his possessions. The merchant can, however, assign to the bank his contractual rights under the agreement, including the right to receive the instalments, but to make the right effective it is probably necessary, in the case of a limited company, to register the assignment to the bank as an assignment of book debts. I say "probably" because the point has not yet, so far as I know, been definitely settled judicially. That, again, would be open to serious objection on the part of sound traders. Therefore, if a bank lends money against the deposit of hire-purchase agreements alone, either its cover is not a complete security or, alternatively, the process necessary to make it

good involves the merchant in a procedure inimical to the best interests of his business." (From an address to the National Association of Finance Companies. New York, 21st November, 1928.)

Two Systems of Finance.

Actually the financing of hire purchases is arranged by one of two systems. Under the first system the merchant carries through the sale as if it were between his customer and the finance company. This means that the finance company assumes proprietary rights in the merchandise, and the agreement between the purchaser and the ostensible vendor carries the name not of the merchant but of the financier, leaving the merchant to carry through a form of sale to the financier to cover the transaction. If this awkward series is conscientiously conducted in its right sequence, the whole transaction becomes perfectly legal, but if, as often happens, the sale to the customer takes place before the sale to the financier, the transaction is of dubious legality. Should there be any question, after default, of re-possession, the goods sold return by this method not to the merchant, but to the financier, whose title is, or may be, doubtful, and it is the financier who will have to re-market them. Whether the merchant is kept in the transaction as a responsible party for loss depends upon whether there is also arranged with him by the financier a form of repurchase or guarantee agreement. The objection of this method is that the trader definitely hands into the keeping of the finance company his trading goodwill. If, for example, I buy one of Verity's Valueless Vacuum Cleaners on the hire-purchase system and pay my instalments to the Frantic Finance Company, which presses me unduly for my payments, I do not grow angry with the Frantic

Finance Company, but with Verity and Company, whose name I associate with the vacuum cleaner and, thus, with the transaction. On the other hand, the trader has eased himself of all credit risk. He has obtained a full insurance, so to speak, against loss while enjoying the full benefit of increased sales.

The second system under which hire-purchase business is pursued permits of the disposal by the merchant to the customer of the goods sold, on a straightforward agreement between them. The merchant then turns to the finance company and gives collateral Bills of Exchange, accepted by the purchaser at the time of signing the agreement, for the debt to become due under that agreement. The finance company having these collateral bills, discounts them or makes an advance against them, the trader assigning his contractual but not his proprietary rights. The actual purchaser, who accepts the bills, is not concerned in any way with, and may not suspect the existence of, the finance company. If instead of bills the purchaser gives promissory notes, they are treated in the same way, the finance company merely functioning as a discounting house. Such discounting business as this cannot, of course, be taken at normal rates, and the "paper" accepted as collateral is bound to be of varying and often uncertain character. Both merchant and discounter will take cover against bad debts, and the merchant can well afford to offer a 10 per cent discount for cash or expedited payments, partly to ease the amount of risk to be covered and partly to get money into profitable circulation behind fresh transactions.

§ 3

I have spoken of consumer credit as an aid to consumption, believing that—other things, being equal—all

aids to consumption are aids equally to production. The other things which must be equal include such essentials as supplies of raw material, sufficiency of labour, adequate distributive facilities, and a continued desire to meet all demands for further supplies of the products consumed. But that desire itself includes the good will of all the human factors involved in production. We need not here re-open the old question whether man is actuated by motives of "enlightened self-interest," but we can pragmatically assume that production will not be at its maximum unless those concerned with it are assured that they secure some benefit from its augmentation.

Expressed at its simplest the production equation works out in this way, that if I can increase the number of units from the same costs, I can either make a higher unit profit from the same sales or sell more at the same profit, or combine both advantages. If I can produce more units from costs slightly higher but not so much increased that they sap the margin between the old and the new profit, it is to my advantage to do so. If my premises and plant represent a tax on production of £X and labour-costs another tax £Y, and my production equals 100 units to sell at £Z, then if I can increase my production to 200 units, I can either sell at £$2Z$ or increase the remuneration to labour by, say, £A, and take from my sales (£$2Z$ minus £A) which is comfortably higher than my original return of £Z only. Equally, it would pay me to work my premises and plant harder or longer if I could lower my average cost per unit, knowing that the increased units would find a market at the right covering price.

Systems of Wage Payments.

Let us now admit that there may be many motives

for applying systems which in effect operate as stimulants to production. An employer may be filled with a stern sense of human justice and so desire to give all associated with him a fair share of expanding profits. Or he may be a timid fellow who fears that if he does not do so the unions will have his men out on strike. Or he may be a scientific business man, who has worked out, with the aid of theorists, dons, journalists, and other interveners, exactly what increase of production his workers can achieve under the stimulation of increased return to themselves. But whatever the motive behind the application of systems of payment which increase production, they are all capable of being regarded as applications of finance to business. Although it has become unfashionable, and even dangerous, to say flatly that money is invested in labour just as it is invested in any other commodity, the fact remains that, from one aspect, this is true. But what is not true is that the aim of the investor is usually to procure the same return for a lower investment—i.e. the same work for less wages. The aim of the investor is not to lower the remuneration of labour, or to get more work for his money, but to get better results from the same work, or better results in return for more work at more remuneration.

If wages are paid on a time principle, so much per hour, per week, per month, or per year—the longer periods being of an agreed hour-content—the employer if he is dissatisfied with the results has the remedy of dismissing the worker and paying his wages to some other man or woman. He takes, as it were, his money out of Jones and invests it in Smith. If wages are paid " by the job " the same remedy is available. If Jones charges too much for the work, Smith can be brought in to do it more cheaply, if Smith is willing to take less. But few wages

payments, relatively speaking, are based upon either straightforward time or task principles. The common custom is to pay what are known as piece-rates. Of these Mr. G. D. H. Cole, in his *The Payment of Wages*, writes—

> "Systems of payment by output are far more various and complicated than time-work systems. In some cases payment by output is the natural and almost inevitable remuneration for certain kinds of service which cannot be easily paid by time; in others it is a conscious device for the acceleration of production. In the first case the system tends to be simple; in the second the employer, in a continual search for new stimuli, tends to adopt more and more complicated devices, and very often a job passes through successive stages of time-payment, piece-payment, and bonus or 'reward' payment. The principle of ordinary piece-work is essentially simple. Instead of receiving so much per hour, the worker receives so much for every operation, or group of operations, performed, at a flat rate per operation, the wages received being strictly proportionate to output. There are, however, many modifications of this system in practice. Where trade unions are strong, they generally attempt to secure a guarantee that the earnings of the piece-worker will not fall below the hourly rate of wages. Not only do the unions seek to establish piece-work on such a basis that actual earnings under piece-work conditions shall be above the standard time-rate; they also demand an absolute guarantee that every worker shall receive at least the standard time-rate, without reference to out-put . . . These systems alike serve to emphasize the time-work basis upon which piece-work usually rests; and, in practice, piece-work prices are usually regarded as fair if they yield about a certain percentage settled by custom above the time-rate to the average worker."

All of these systems, including what Mr. Cole has called "reward" payments, remain within the ordinary ambit of the hiring agreements between employers and employed. They are methods of individual wage payments. Whether the reward be a bonus on time saved, or on a production limit overpassed, it is still a recognizable part of a given workman's remuneration. As such it can be estimated

in advance by whoever is concerned with the internal finances of the enterprise, even if the estimated expenditure be dependent upon a variable contingency. The total cost incurred can be deducted as an omnibus item when net profits are being arrived at, and the amount available for distribution to shareholders reached.

Profit Sharing.

But there are two incentives to production which seem to fall into another and special category. They are profit-sharing, in any of its simpler forms, and the endowment of certain workers with shares in the enterprise. (It is not my province here to discuss the wisdom of either system from the viewpoint of business management, of social expediency, or of "class conscious" political organization. Such aspects can be left to the occupants of debating halls, after-luncheon speakers, and soap-box orators.) Profit-sharing as a direct incentive to output is not on examination found to be of much real potency. On the average such schemes show to the worker an addition of some 5 per cent or 6 per cent on wages, whereas piece-rates are generally able to give him an increase of at least 33⅓ per cent (thirty-three and one-third) on time-rates. But profit sharing, in addition to piece-rates or in industries where piece-rates are not applicable, has an indirect effect which is valuable. It binds the worker to the general interests of the enterprise, and it quite definitely affects the psychological relationship of those who supply capital and those who supply labour. It is productive of internal goodwill, which, while it cannot be shown on a balance sheet, is an asset as least as palpable as many external goodwill items.

The financing of profit-sharing schemes is a matter for

individual ingenuity. As a broad base it may be said that the most satisfactory method is to regard the totality of labour ranking for a share as a *bloc* of deferred shareholders without scrip, and after a margin of profit has been shown equal to a fair return to capital to arrange a division of the sum above that level on terms which will neither seem ludicrous to labour nor unjust to capital.

Worker-Shares.

Worker-shareholder systems are of different kinds. In some cases special shares are allotted to workers without payment, out of a special reserve. In others, the workers may apply for and buy, on special terms, the category of share reserved for their purchase. These shares may or may not carry voting powers, but they rank as capital, and the addition of such shares is a genuine addition to capital liability. Broadly speaking, the allocation of worker shares is tantamount to a funding on their behalf of a *bloc* share in profits. The recipients are placed under an obligation to re-sell their shares to the company on certain contingencies, such as a cessation of employment with the firm, or death.

The actual financing of these schemes is in fact of less importance than their successful application as a change in economic relationship. The most skilfully devised scheme of profit sharing which affects the workers as a contemptuous or patronizing display of shareholders' charity will be money ill spent. Worker-shares which accentuate the fact that they carry no share in the control of the company may do more harm than good to the internal goodwill they are designed to cement.

Whoever is responsible for the broad financial policy of an enterprise can only regard himself—or themselves—as standing in regard to such incentives much as the

Chancellor of the Exchequer was seen in an earlier chapter to stand in regard to Government policy. If the Board of directors, or the senior partner, insists upon profit sharing, or the creation of worker-shareholders, as an expression of appreciation to the workers, or as a desirable factor in the joint relationships, the finances of the concern must perforce be adapted to the new departure. That profit-sharers are never loss-sharers, and that a bad period, which causes all dividends to fall or to be passed, reacts with increased depression upon the new class of shareholders, are considerations which will continue to affect the financial controller, and may result in a change of policy towards reserve allocations not good for the eventual standing of the company's finances. The golden rule is never to allow the circumstances under the force of which new capital was created from reserves to influence financial policy, and never to allow the fact that portions of the total profits are " earmarked " in advance for special distribution to influence the allocation of the remainder from strict financial and business principle.

§ 4

At a time when the nation is compelled to support between a million and a million-and-a-half of unemployed workers it is frequently suggested that industry should so arrange its finances that it will make provision, section by section, for its own unemployed. The choice is so phrased that the industrialist is asked whether he will continue to support the burden of non-productive consumers through his contributions to the State, or whether he will devise means whereby he will carry that burden as a direct charge. The suggestion has never reached a formulation sufficiently detailed to bring it within the

range of practical politics, and, in any event, the social and political complications, and the risk of making static the sectional populations to be supported, would make any change of system impracticable. It is, none the less, true that under whatever system the unemployed are sustained, it is industry which actually, in the final resort, carries the burden of their support. It is also for the comfort of industrialists that a new way of stating the unemployment position has been found.

Sociologically the cry for " work or maintenance on full wages " is indefensible. The onus of finding means of self support for a man is not upon the community, but upon the man. If full wage rates are paid to a man in idleness the incentive to find work is often removed altogether, sometimes lowered, and rarely left unimpaired. But as a matter of economics the country may well be able to afford full wage subsistence to its unemployed without seriously damaging its general position.

Distribution of Leisure.

If I employ 100 men to produce 100 units but, by the introduction of a new method or a new machine, can continue to produce 100 units by the employment of only ten of them, the position of my enterprise—leaving aside for the moment the cost of my new machine, or of working my new method—is unchanged whether I work ten of them for the old hours and pay full wages to the ninety idle, or whether I work them all for one-tenth of the old hours, or whether I dispense with ninety and give the ten a ten-fold increase in wages. My own position may be changed if I continue to pocket my old profit but only pay ten men for the work of the original hundred. If we assume that I do not for some good reason, wish to increase the number of units produced, and that I have no

wish to increase my personal gain, but that I decide to keep only ten men at work and pay pensions at full wage rate to the ninety, I have then created an unemployment problem. In my community of 101 persons—100 workers and myself—we have an unemployed population of ninety persons. If I press for some means of finding new work for the ninety, I shall conduct a political agitation for some cure for the prevailing unemployment. On all grounds I shall be right in so doing. But I should be committing no offence against logic or fact if, instead of calling my problem an unemployment problem, I called it "the distribution of leisure problem." Indeed, if there were no possible or apparent means of increasing employment, or of finding a sale for more of our production units, one of the employed ten workers or an energetic member of the unemployed ninety might well start an agitation on his own account for a new leisure policy, declaring it to be absurd in our community to give ninety men 24 hours a day of enforced leisure and to allow only 16 hours leisure to the other ten.

If I were able to use two of the new machines, and to employ twenty men to produce 200 units, as against the old 100 units produced by the original 100, the unemployed eighty workers might well find that their enforced leisure was accompanied by an increase in those amenities the quantity of which determines the "standard of life." They might still object to the faulty distribution of leisure in the little community.

Population and Wealth Units.

With many complications, it is this situation which has developed in every industrial nation. The sudden rise in production following the industrial revolution brought with it a rise in population, but no population kept pace

with the increase in production facilities. Ruskin and Samuel Butler denounced machinery on no mere sentimental grounds, although not until Belloc detected the cause of the weakness in the financing of it, and Shaw the weakness of our method of manning it, were the early denunciations taken at all seriously.

Again, still regarding the matter in its economic aspect only, it is of little moment whether a relatively small number of pleasure-seeking, unemployed, cultured patricians consume, or take out of the country to France and Switzerland or Norway and the big game regions, a given number of wealth units, or whether a larger number of work-seeking, unemployed and uncultured plebs consume in idleness at home the same number of wealth units. The proportion of population to wealth units available is the vital thing.

Let me here re-emphasize with all the force at my command that the economic aspect thus shown is a minor aspect when the problem of unemployment is viewed by the statesman or the sociologist. The problem is not to satisfy ourselves that we can afford to support a certain number of unproductive citizens in enforced idleness without imperilling the economic security or standard of living of the rest. The problem is to make the idle again productive. But viewed solely from the aspect of community finance, the mere fact that 10 per cent of the adult population is enjoying full leisure and the remaining 90 per cent is enjoying only partial leisure does not affect the balance between the total payments out for subsistence and the total payments in for successful trade. If the 10 per cent were employed in such a way that they did not increase the national net income, their mere employment would not affect the national balance sheet. An ardent social reformer of ascetic mind might

even contend that a large proportion of citizens now drawing wages for work done could be relieved from their work, given their wages as pensions, and the balance sheet of real national net income show no change.

§ 5

The national income, of which I have just spoken, is itself of some interest to anyone who desires to envisage the whole field of finance. Those who desire a close and detailed, but still brief, exposition of the manner in which statisticians estimate it will find invaluable the Presidential Address delivered to the Royal Statistical Society by Mr. A. W. Flux in 1928. The method by which the estimated real income is reached entails the division of national assets and activities into three categories of value—material goods produced, personal services rendered and exchanged, capital services rendered by houses, schools, institutions, and the like. Taking the income for 1924 Mr. Flux obtained the material output of the United Kingdom by taking first the value of imported material at £1,137,000,000, of which goods worth £497,000,000 went direct to consumers and goods worth £640,000,000 went as raw materials to manufactories. To this last item was added home produced raw material, the two together being worked up into an industrial output having a value at the works of £2,478,000,000. When to this is added the value of farm and garden produce, the total of material production is reached, at a value of £2,655,000,000. From this 27 per cent is to be deducted for export and a figure between £760,000,000 and £1,130,000,000 for costs of transport and merchanting. Other items, such as Excise duty, and goods going direct to the consumer, bring the total value of goods at the consumption point to a value between £3,350,000,000

and £3,800,000,000. From this figure must be deducted an estimate for goods used to replace capital, placed by Mr. Flux for the year in question at £300,000,000, leaving, on the lower estimate, a value of £3,050,000,000. To this foundation figure must then be added the value of capital services, £225,000,000; the value of personal services, £425,000,000; and a final item to represent the value of new investments abroad, £50,000,000. The total national income thus works out at a figure between £3,750,000,000 and £4,200,000,000.

Effective and Non-effective Factors.

The rendering of valueless services by units of the population now unemployed would not affect that figure, and services upon which a value could be placed if accompanied by a rise in consumption of higher value might cause the solution of the unemployed problem actually to lessen the income balance.

It is by the reduction of economic operations, and political changes, to terms of finance that they can be separated into "effective" and "non-effective" factors in wealth production and wealth accumulation. To reduce the matter, again, to an extreme simplicity, if I pay a footman £2 a week and his "keep" to act as a decoration in my hall, and then, in a fit of impatience, turn him into a gardener, only to find that while he increases the productivity of my garden he also increases his appetite to an equal amount, I have not altered my own financial position. If his appetite increases more than the margin of extra productivity, and in addition he demands higher wages, I am actually worse off by my fine moral gesture of changing a drone into a worker. On the other hand, I shall probably have benefited the community by changing a vain and idle blockhead into a

happier and nobler citizen. I may even find that with the passage of time his productivity in my garden will out-pace the increase in his appetite and his demands on my purse. The point to be marked here is, that while a financial analysis of economic and political changes provides a clue to their immediate wealth value, it does not, on a negative finding, prohibit the anticipation of eventual value.

CHAPTER XXIV

FINANCE AND THE FUTURE

THE practice of finance has changed much in the three decades which have passed since the opening of the present century. It is changing rapidly still. Owing, as I think, and have attempted elsewhere to demonstrate, very largely to the unconscious education of small income makers into the habit of holding securities, by the creation of the war savings movement and its propaganda, the financial public has ceased to be a small and relatively select community dealing in a relatively circumscribed market. Joint-stock companies have not only increased in number but have widened tremendously their capital bases. We have even reached the Gilbertian position wherein certain workers who happen to hold shares in certain enterprises press for dividends, and yet complain that the " system " is bearing hardly upon their exploited comrades. The widening of the investing population has, not unnaturally, given new opportunities to those whose financial astuteness is in inverse ratio to their social morality. The necessity for making a wider appeal for capital has added to the preliminary costs of company flotation. This, in its turn, has created new associations of persons engaged not in direct financial practice, but in the supplementary work of furthering the publicity which is needed if capital is to be readily obtained, and, once obtained, is to be kept at a market value approximating either to the value of the company or the value which manipulators desire it to seem to possess.

The State—"unable to stoop and see the rogues flourish and honest men droop"—has already taken some cognizance of these changes, and as far as is possible the future of financial practice has been laid out legislatively by the Act of 1929.

"Industrials."

It is quite obvious that never again will the investing public shrink to its old proportion of the total community. The small denominational share has come, as the phrase runs, to stay; and the habit of thrift, triumphant even in bad industrial times, will create a stronger flow of invested capital as times improve. The present fancy of the small investor for industrial securities may not persist, but there is no reason why it should not. With the growth of staff pension schemes and the facilities which are available for self-insurance against old age and its needs, the invested money of the public is less a provision against retirement from wage-earning than a supplementary form of provision augmenting those just mentioned. The small investor taking up the small denominational share will tend to take more risk than his father did, and to him the industrial security will present more attraction than gilt-edged securities. We shall see cycles of confidence and loss of confidence in industrials, but over lengthy periods it seems probable that the industrial market will continue to attract the bulk of the small investor's money.

Should there come a legislative period of heavy taxation for schemes of social reform, or for the initiation of nationalization of industries, the present tendencies will be checked. All prophecy will be rendered futile. A legislative censorship of investments, threatened in the full programme of one political party, will likewise

render our prognostications futile. But given freedom from any violent change in the economic structure of the State, we may assume that the flow of capital into industrial ventures will not only continue, but will grow stronger. The incidence of the stamp duties will cause companies to rely more upon small nominal capitals, and to turn to loans, of one kind and another, for their working "capital." It seems probable that the bearer security will grow in popularity as against the registered share and registered or inscribed stock.

With the growth of new companies, calling upon the small investors' money for their capital, there will be a continuation of the present movement towards the amalgamation of companies. Whether "rationalization" will fulfil the high expectations of its more enthusiastic advocates we may doubt. The looked-for economies very often do not show themselves when the amalgamated interests begin to operate as one, and the increasing size of an enterprise tends to create a bureaucratic method of administration which has not always proved as efficient in practice as in theory.

"Parent and Offspring" Finance.

One detectable tendency will probably continue for some few years to come. It is the tendency shown by certain company promoters to float a parent enterprise and then, with little delay, to evolve from it a number of associated enterprises which appeal for capital chiefly on the strength of the response to the original appeal for the parent company. Whereas in older days I, as a promoter, would float my "Invisible Paints, Limited" and rest satisfied either with its commercial success or its use as a market counter, to-day I should float first "Invisible Paints, Limited" (. . . have pleasure in

announcing that the lists closed at 10.15 a.m., the issue being many times over subscribed . . .) then "Invisible Paints (Foreign) Limited" (. . . have pleasure in announcing that the lists closed at 10 o'clock a.m., the issue being heavily over subscribed. Country applications received by first post, etc., etc. . . .) then "Invisible Paints (Holdings) Limited," and as many more companies as I could conceive and persuade the public to purchase from me as vendor.

This practice raises several questions of more than academic interest. Are the proceeds of the sales to the subsidiary companies of rights in my "invisible paint" profits or not profits? The rights are certainly assets of the company, although they are by no means firm assets.

Again, is it to the good of the financial community that I, as vendor, should fix what price the new company, as purchaser, shall pay for these rights, which are less rights than expectations, and by means of paper profits lure the investing public to become, in actuality, the purchasers of both companies, to my great advantage? There is nothing legally wrong, or even morally dubious, about the formation of a series of associated companies to take over the rights of the parent company for exercise in other territories or in other ways. It may even be (as we shall see in the next paragraph) wholly desirable that the parent company should exploit its right by means of such sales rather than through the ordinary processes of extended activities. But legislation should be clearer as to the exact significance of the sale of rights, and should define whether proceeds from such rights when sold can be treated as profits. In any event, the investor will more clearly realize, as he becomes more familiar with the process, that companies formed as the sudden progeny

of a parent which is itself a speculative venture must be supported purely as speculative risks.

Legitimate Offspring.

It has been argued that the sale of rights as conducted under post-war practice is to some extent justified, and even rendered necessary, by the world-wide imposition of tariffs. These barriers, it is held, make it almost prohibitive to import certain classes of goods. A new company with a small capital and an excellent patent may only be able to exploit its wares in other countries by manufacturing those articles behind those tariff barriers, which would involve heavy capital expenditure. Where such circumstances arise there is no objection to the rights being sold to foreigners, either for cash or for cash and shares, as a bona fide transaction; but, even so, it would surely be better to await the development of the parent company, with a consequent normal expectation of an increase of capital, when the foreign field could be exploited as a normal expansion of business.

It must not be forgotten that tariffs existed before the war, and that many great enterprises then managed to exploit all fields without disposing of rights with suspicious haste and apportioning the proceeds to profits. Also it must be borne in mind that the sales of rights, to which in the preceding paragraphs I have objected, are too often engineered with no compulsion from tariff circumstances. Rights have been sold within the same country, or to persons in countries where no tariff barrier of any formidable size existed, and from obvious motives. We thus have the example of a company which for a first year's working shows a net trading profit of £250, yet in that same year declares an interim dividend of 10 per cent, absorbing a sum of some £6,000. This sum is met out

of the proceeds of a sale of foreign rights, realizing £10,000 in cash and £40,000 in shares in the " foreign " company, the £40,000 in shares rapidly falling to a market value of little more than a quarter of its nominal worth. The moral of such a transaction is so glaring that it demands no emphasis. In such a case no consideration of tariffs has operated.

There is a legal adage that " hard cases make bad law." To leave open an avenue for rogues because a few honest men may by the closing of that avenue be hindered, or delayed, on their lawful occasions is bad statesmanship, worse statesmanship, indeed, than its opposite, which is to penalize a majority of honest men because a few rogues must be restrained. In such matters there is a discernible balance of good. If there is good cause for the hasty sale of rights, for the sudden littering of progeny, it can be shown, and it would be no great hardship if it had compulsorily to be shown. But no legal restraint on activity is suggested. What is needed is only, as I have said, a firmer definition of the significance of a sale of rights and the treatment as profits of the proceeds from such a sale.

Weak Underwriting.

One great weakness which was revealed by the aftermath of the " boom " of 1928 was the prevalence of unsound underwriting. Not one or two companies only, but a small crop of them, had, in 1929, to report at the end of their first year's trading that they had made no progress, or poor progress, because the underwriters had failed to pay for the shares with which they had been left. In some cases companies, whose industrial justification was not in doubt, were forced from that cause into premature liquidation. The procedure of underwriting includes the employment of underwriters (see page 225) who

in turn employ sub-underwriters. Until quite recent years underwriting was only undertaken by certain houses of high repute and known resources, who, for the protection of their own good name, would only " farm out " underwriting to persons whose own stability was assured. When, in 1928, there was a grotesque boom in new flotations, new finance houses appeared whose own resources were negligible and who passed underwriting to their friends and hangers-on with no expectation that any shares would require to be carried, since the small investor had apparently lost his head and was prepared to invest in any rubbish which was offered to him. In effect these persons took long-odds against being required to take up shares, and when they lost the wager were unable to pay the forfeit.

When this happened to a company the directors had but one remedy, which was to take legal proceedings against the defaulters. Unfortunately, legal proceedings or the imposition of a legal penalty on the defaulters cannot in such circumstances repair the damage to the enterprise and its shareholders. It may be a vengeful gratification. It may even be something of a deterrent to others. But it is certainly not a reparation. The best commercial enterprise is helpless if its initial finances are disorganized, as they may be by defaulting underwriters.

It is impossible to suppose that the future will not disclose a remedy for this weakness. Several have been suggested. There is, of course, one " fool-proof " method of protection. That is to demand from the underwriters a cheque for the amount represented by a full allotment of the shares they undertake to carry in the event of no public response to the invitation to subscribe, and to return to them the amount not required when the shares have gone to allotment. In practice such a method would

not be workable. It would leave the possibility of underwriting in so few hands that many legitimate and desirable enterprises would never come to birth, to the community's loss. Much might be done if it were rigidly enforced that at least the amount of application money were always firmly deposited.

Vendors Who Suffer.

It is not only the new company which suffers. There was recently an outstanding case in which the issuing house received a substantial fee and a sum in advance of commission, whereas the unfortunate vendors were left to take debentures in lieu of the agreed purchase money. In this instance out of a total of 560,000 5s. shares, calling for £140,000, unpaid instalments amounting to £63,436 were shown in the statutory report, and the company was left with £25 cash in hand and at bank.

Defaulting underwriters may bring a promising venture to premature grief, and weak underwriting will always play havoc with the market value of a company's securities. When an issue fails to go well, dealers are chary of making a good market. Strong underwriters need not unload their holdings on the indifferent market which results: weak underwriters must, and a bad position is made worse.

The original directors of some companies which have suffered in this way seem to think that it is sufficient to plead weak underwriting as an adequate excuse for a failure of results to reach prospectus promises. That excuse is not sufficient. The choice of an issuing house, which in a simple chain means the indirect choice of sub-underwriters, is with the promoters. If they make a bad choice, theirs is the blame for all that follows. Such responsibility must in the future be more acutely realized than it has been in the past.

Change of Directors.

Allied to weak underwriting is yet another flaw in present practice which will doubtless be amended in the future. It is possible now for individual directors to leave their boards and for others to take their places without immediate notification being given to the shareholders. In one instance an original director actually resigned his seat on a board because the underwriters had failed to fill their obligations. But his resignation was not known before the statutory meeting. In other words, the shareholders remained unwarned of anything wrong for some unnecessary time.

Immediate notification of changes of personnel is desirable for two reasons. If a man resigns because he does not feel happy about the progress or policy of the company, the shareholders have a right to know of the uneasiness which has robbed them of the services of an elected officer. If a man resigns because his colleagues feel that the board would be better without him, the public has a right to know that the retired director is no longer in his old position. It is neither right nor safe that a man should continue to receive the credit appertaining to a director of a particular company when he has ceased to hold such a position.

Immediate notification of resignations and appointments will, no doubt, be secured in the future either by some amendment to company law or by Stock Exchange action, simply brought about by an insistence that such notification must be ensured under the articles of association of any company seeking permission to deal.

The Fetish of Dividends.

In an earlier chapter I have mentioned that the creation of deferred shares has tended to lure some companies

into the payment of dividends where a more cautious and conservative view of finance would have retained the allocation for reserves or other stabilizing purposes. There is before me, as I write, a balance sheet which shows a company with an overdraft of over £40,000, no cash in hand for working capital, a creditor and debtor position which signifies a trade already too large for its size and resources, and a balance sheet total of only £500,000 odd. Yet this company proposes two things—to pay out £30,000 in an ordinary dividend, and to raise its nominal capital by a further £200,000. To the experienced observer one of two things, or possibly both, has influenced the company. Either it was desired to show a dividend to the ordinaries which would permit the holders of deferred ordinaries to take an apportionment, or it was desired to pay the ordinaries a good dividend in order to give to the new capital issue an attraction it would otherwise have lacked. A hundred and one considerations may have weighed with the controllers of this company when they chose to declare the dividend, and unless one is cognisant of the whole trading position criticism is a little foolish, but when so many companies choose to adopt a similar policy it is not unjustified to assume that there exists a tendency to elevate the dividend into a fetish and to reduce from their once proud positions the rival gods of reserves and depreciation allotments.

More pleasant tendencies which are observable include a lessening faith in the wrong sort of "bucket-shop" keeper. (A bucket-shop is the office of an outside broker. The dealings of outside brokers are not regulated by the rules and regulations of the Stock Exchange. The bucket-shop keeper is thus allowed to advertise freely.) While many outside brokers are estimable and honest people,

some are neither estimable nor honest. By means of financial "newspapers" under their control and floods of circular letters, the less honest often persuade innocent and unsuspecting persons to buy shares which are not worth buying or to take options which cannot be made to pay. The genuine financial press is now so widely read that the small investor is being tutored into a distrust of outside brokers who advertise and send free and unsolicited advice. The portion of the Act of 1928 first made operative, and now part of the Act of 1929, has made illegal the peddling of shares, and this step, in conjunction with a growing wisdom, is likely, for a time at least, to restrict the operations of the more questionable type of outside broker.

§ 2

Nothing, perhaps, is more indicative of changing practice than the alteration which is taking place in the status of the Company Secretary. Quite apart from the valuable effect upon company control of the existence and disciplinary and educative work of the Chartered Institute of Secretaries and the Incorporated Secretaries' Association, there is now evident a community-will (if I may borrow an ugly term from the psychologists) and a legislative intention to increase the responsibilities and influence of the secretary. The Companies Act of 1929, places the Company Secietary on the same footing as his directors with regard to statutory liability.

1. Under Sect. 18 of the Act of 1908, the obligation to supply to any member on application and on payment of one shilling a copy of the memorandum and articles of association was an obligation imposed on the company. The obligation under Sect. 24 of the Act of 1929 is imposed on the directors, managers, and secretary of the company, and the penalty (£1 for each offence) is "personal to any one of them who

knowingly and wilfully authorizes or permits" default. Further, the new Act imposes the like personal penalties should a memorandum supplied not include any alteration to date in its terms.

2. The obligation imposed by Sect. 96 of the new Act to keep an index of the share register of a public company, "unless the register is in such a form as to constitute in itself an index," is an obligation of the company, but the penalty for default is recoverable from any director, manager, secretary or other officer proved to be concerned.

3. The balance sheet included with the annual list and summary may, if thought fit, be signed and certified by the secretary. Obligation, in the event of default in the return, which under Sect. 26 (4) of the 1908 Act was limited to "every director and manager," is imposed by the new Act on "every director, manager, secretary, or other officer."

4. The secretary also may by the new Act sign the annual return of mortgages and charges, and is in like manner included in the liability in the event of default. The same revision of liability applies to Colonial (now termed Dominion) registers.

5. The obligation under Sect. 44 of the Act of 1908 to file within fifteen days a copy of any special resolution increasing the share capital beyond the authorized total, was an obligation of the company, with the penalty in the event of default recoverable from "any director or manager" responsible for it. The penalty is now made recoverable from "any director, manager, secretary or other officer" implicated.

6. The new Act prohibits a company from making (with certain exceptions) loans to any person for the purchase of its shares. The penalty for contravention is made recoverable from "every director, manager, secretary or other officer who knowingly and wilfully authorizes or permits."

7. The secretary is also now (Sect. 92 of the new Act) included in the liability for filing notice of any change in the address of the company's registered office.

8. In like manner the secretary is (Sect. 118) included in the liability should there be default in filing copies of any special or extraordinary resolutions.

9. He is also included in the penalty should there be refusal to allow any member of the company to inspect the minutes of the company's general meetings, or to furnish on application copies of the minutes at the statutory charge.

10. The right conferred by Sect. 98 of the new Act upon members to inspect the register of directors and managers, and

upon other persons on payment of 1s., together with the obligation to file a return giving the prescribed particulars, involves the secretary as well as the directors should he be concerned in refusal or default.

11. With regard to the payment of commissions in consideration of subscribing for shares—which the new Act limits to the rate of 10 per cent—a return showing the number of shares so subscribed for is required to be put upon the file. Default is made (Sect. 43 (5)) penal, and the secretary is included with the directors in the liability if he "knowingly and wilfully authorizes or permits."

12. It has been made by the new Act obligatory to send a copy of the balance sheet, directors' report and auditors' report to "all persons entitled to receive notices of general meetings of the company" not less than seven days before the date of the meeting, and here also there is a penalty for default recoverable from the secretary as well as from any director or manager concerned.

13. Members of a public company not entitled under the articles to receive notice of a general meeting, together with any Debenture-holder, are empowered (Sect. 130) to demand a copy of the balance sheet and report gratis, and here, too, the penalty in case of refusal is recoverable from "every director, manager, secretary or other officer" implicated.

14. If a company registered in England acquires after the coming into operation of the Act any property subject to a charge or incumbrance, a copy of the deed creating the charge must be filed within twenty-one days. The secretary, if a party permitting the default, is liable to the penalty enacted.

15. A like extension of the scope of liability is imposed in Sect. 88 (2) for failure to register other mortgages and charges.

16. Filing of the prescribed copy of the order of the Court authorizing a reorganization of the company's capital is made an obligation of the secretary as well as of the directors.

17. The secretary as well as the directors is also made responsible for the filing, within seven days, of a copy of the Court's order authorizing any scheme of compromise or amalgamation.

18. Under the Act of 1908 (Sect. 121) the directors of a private company, which by alteration of its articles or otherwise becomes a public company, are required to file within fourteen days a statement in lieu of prospectus. The secretary is now (Sect. 27 (2) of the new Act) included in the liability should there be default.

19. By Sect. 185 of the Act of 1908, publication in the *London Gazette* of notice of voluntary winding-up is an obligation of the company. The notice is required by the new Act (Sect. 226 (2)) to be published within seven days; and default is made a personal liability of the " directors, managers, secretary or other officer " concerned.

20. Similarly, default on the part of the company in complying with the revised provisions as to winding-up—calling of a meeting of creditors, laying before them a statement of affairs, etc.—is made (Sect. 181, etc.) a personal liability of the directors and secretary.

Now that such provisions are incorporated in the new Consolidation Act, it will no longer be possible for the Secretary to plead that he acted under the instructions of his directorate, and so escape liability. When instructions involving an illegality are issued, it is upon the Secretary to refuse compliance. This not only raises the legal and general status of the official, but it surely portends the coming of a race of Company Secretaries who must, to fulfil their responsibilities, be men of the highest calibre and of fearless will. If the recent determination shown by certain statesmen to rid companies of " parasite directors " —Mr. Baldwin's strong phrase—be carried into effect, companies in the future will thus be equipped with Boards of Directors who are practical men, Secretaries who can prevent those Boards from taking actions which may not be strictly legal, and auditors who are the avowed watchdogs of the shareholders against any possible malfeasance of Board and Secretary in combination.

Auditors in the Future.

The position of auditors is also likely to be strengthened. We have already, in an earlier chapter, discussed the difficulties which confront accountants, and have examined the different views which are taken of their exact responsibility. A notable scandal in the early months of

1929, when a firm of auditors was found to have certified, innocently and in all good faith, a balance sheet which contained false statements of trading profits, emphasized the fact that while an audit can reveal the minor defalcations of isolated officials, it very often cannot detect, without special investigation, a deliberate fraud by the company as an entity. The special investigation needed for such detection would occupy more time and labour than most firms could give on the usual remuneration afforded to them. Again, as I have said, no auditor can be a practical valuer. He must accept valuations offered to him if he has no good reason to suspect deliberate fraud. He must also accept, very often, minor books in which postings are accurate, and vouchers and counterfoils tally with postings, despite the fact that carefully manipulated malpractices have rendered false the position which such books reveal. The certificate which the auditor gives guards him against the future revelation of false valuations or concealed frauds condoned by the company presenting the books for audit, but under the operation of the Act of 1929 he will enjoy the right of revealing to the shareholders any doubts he may harbour or any explanations not included in the formal certificate. It must, of course, be remembered that the world rightly organizes itself on the assumption that most men are honest, and that protection is only needed against the occasional rogue. Otherwise the cost of vigilance would be to some companies prohibitive, and to most companies unduly heavy. Broadly speaking, the function of the auditor is to assure the shareholders that the company is itself exercising the requisite vigilance over its servants, and that the directorate is not party to dishonesty. It is not, strictly speaking, the duty of the auditor to compel the company to depart from a principle of undue reticence,

although the modern auditor does bring his persuasive pressure to bear when such reticence exists.

The compulsion upon companies to furnish a balance sheet showing greater classified detail, will, without doubt, be followed by a compulsion to show not merely a Profit and Loss Account, but a Profit and Loss Account of some detail.

§ 3

Of the future of banking it is, perhaps, indiscreet to write, but even the banking layman can detect certain signs which are of the utmost significance. The continued trend of affairs is towards the further amalgamation of small banks either with each other or with "the Big Five." The recent taking in of "The Lancashire and Yorkshire Bank" by "Martin's Bank" has again shown that the combined business of two amalgamated banks exceeds that "added" business of the separate entities even before the economies of amalgamation have had time in which to make themselves properly felt. Whatever ill reactions follow the rationalization of industries, they do not follow the amalgamation of banking houses.

But of far greater importance than the tendency to amalgamation is the recent readiness displayed by the great banks to depart from the rigid practice of the past, and to participate in the restoration of great but afflicted industries. The formation of the Corporation which is to operate the Agricultural Credits Act, and the formation of the Lancashire Cotton Corporation, would not have been possible had the banks cared to interpret narrowly their communal function. In the past the tradition of English banking was that between financing industrialists and participating with industrialists in the risks and operations of their industry, was a line drawn over which the banks would not step. In Germany, banks have often

been the virtual sleeping partners of industry. In England it has always been held—I have, myself, in this book laid it down as a primary canon of sound banking—that it is not the duty of the bank to supply fixed capital. The formation of the Lancashire Cotton Corporation, Limited, in 1929, is an example of English banking, not leaving, but adapting, the old English tradition. Not only was the Bank of England consulted at every step towards the creation of that Corporation, but other banks, particularly those carrying the heavy obligations of many mills, exerted pressure to persuade their creditors to come into the scheme for the restoration of the industry as a whole, and gave to the Corporation the necessary finance pending its isssue of 5½ per cent Convertible Income Debenture Stock. It is not possible here to enter into the constitution of this Corporation, or its purposes, but the student will find both worthy of study, and it is more than possible that in the history of Banking this formation will mark the beginning of a new period in which the old rule is less rigidly applied and co-operation with organized industries is not uncommon.

The Bank of England.

Not without importance in any estimate as to the future development of banking is the practice of the Bank of England of adding to its Board men of the widest financial experience outside banking. A certain change of Government might in this generation mean an attempt to alter the constitution of the Central Bank. A process of "humanization," having its inception within the institution and not outside it, has already begun, and, whether the system is to suffer violent political assault or not, we may expect some change in the relationship of the Bank to the public.

It is also evident that the endeavour of the future will be to keep the Bank Rate stationary when it cannot be lowered, and the Money Market will find that a gold efflux will no longer disturb rates as it might have done a few years ago. The resources of the Bank against gold efflux, in addition to a raising of the rate, include possibilities of Central Bank negotiation not present some few years ago, and an increase of the fiduciary issue under the powers of the Currency and Bank-notes Act of 1928. This, again, means that the convenience of industry, as such, is becoming more and more the primary consideration of the Bank, and that the old indictment, that industry was too frequently made the victim of the Money Market, is losing its sting.

§ 4

With the growing need for the political electorate to master the intricate relationships of finance and politics, politics and economics, economics and social standards; and the probability that the more scientific application of invention and more scientific management of industry will result in a larger proportion of the people having surplus income to turn back to capital uses, the need grows, also, for popular education in what were once regarded generally as the dull studies of pedantic academicians or as the private intellectual distractions of a select governing caste. The larger the constituency of the population interested, from whatever motive, in finance, the more simple, rather than the more complex, will grow financial practice. The Bank will tend more and more to simplify Money Market practice; the Foreign Exchanges will, as time passes, lose their mystery, and may even be reduced to "pegged" rates; general investment will fall more and more into the hands of Investment

Trusts conducted by competent financiers; company flotation and company financial management will tend to follow recognized formulae. So, at least, do I see the future of finance.

The myth of the pool of capital has already been, for a vast majority of citizens, exploded. The bogey of " the bloated capitalist " ceases to frighten the small investor who is himself, or herself, a capitalist without being bloated. The fear or distrust of banks is dissipated as the population of small wage-earners learns to use the banks for a variety of services, and as the banks cease to remain rigidly aloof from industry, and so placate the wrath of individual industrialists who cannot obtain the accommodation which they fancy they have a right to procure on whatever security they may tender.

The Basis of Confidence.

During the later years of last century, and the early years of the present century, confidence, the basis of all credit, was often conjured into being by the cultivation of mystery. Confronted by monetary systems and financial practices which he did not hope to understand, the normal citizen was persuaded to place his faith in certain High Priests of Finance, either technical or political, and his confidence in them was then applied to the system which they operated. We have passed that stage. General confidence can now be generated not from ignorance depending upon trusted guides, but from knowledge generally enjoyed. The specialist, it is true, will become more and more necessary, but he will serve a financially enlightened, and not a financially mystified, community. It may even be that, in some not far distant future, all schoolboys will be taught to read a balance sheet and a prospectus as they are now taught to read a

map or a graph, and to make a Company analysis as they now make a chemical analysis. When that day comes, a volume such as this will be regarded, let me hope, with the amused tolerance we give to the horn-books of our semi-literate ancestors. Until that day comes, it may serve as an introduction to the specialist masters upon whose researches, experience, and formulations it so shamelessly rests.

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